

**RUSSIAN ECONOMIC
FOOTPRINT
IN THE WESTERN
BALKANS**

CORRUPTION AND STATE CAPTURE RISKS



**CENTER FOR
THE STUDY OF
DEMOCRACY**

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The Western Balkans have become one of the regions, in which Russia has increasingly sought to (re)assert its presence in the past decade. In attempt to improve the understanding of the impact of the interplay between existing governance gaps and the inflow of authoritarian capital in the region, the Center for the Study of Democracy developed an assessment of the Russian economic footprint in Serbia, Montenegro, Macedonia and Bosnia and Herzegovina. Although in absolute numbers Russian investment in the region has increased by more than EUR 3 billion, Russia's economic footprint as share of the total economy in the Western Balkans has shrunk or stagnated in the wake international sanctions over the annexation of Crimea. Because Russian businesses are concentrated in a small number of strategic sectors however – such as banking, energy, metallurgy and real estate – the four small, energy-dependent countries assessed in this report remain vulnerable to Russian pressure. An overreliance on Russian imports, coupled with an expansion of Russian capital, has made the governments of the Western Balkans particularly susceptible to pressures on strategic decisions related not only to energy market diversification and liberalization, but also to Russian sanctions, and NATO and EU expansion.

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INTRODUCTION

Over the past decade, Russia has increasingly sought to reassert its position as a global power and to present itself as alternative to the Euro-Atlantic model of liberal democracy and a free market economy. The Western Balkans is one of the regions in which Russia has been most active in this respect. Thus far, the region has more or less stayed on its course toward NATO and the European Union (EU). But Russia's meddling in the region has enhanced space domestically for political opportunists to try to avoid implementing necessary reforms, particularly those related to strengthening the rule of law and curbing of autocratic tendencies – as a result undermining civil society and the media, leading to democratic backsliding and an economic slowdown. NATO nevertheless could accept Montenegro as a member, while the EU has put forward the Berlin Process, which aims to speed up economic development and transformation. In 2018, the EU will propose a new Enlargement strategy aimed at providing a clear path for the Balkans to integrate into Europe. Tackling outstanding “governance gaps” – deficits in the rule of law, and weak democratic and market institutions – in the Western Balkans is critical to limiting the effects of so-called “corrosive capital”¹ – funds flowing from non-democratic states such as Russia that both take advantage of, and exacerbate the challenges facing struggling democracies – and to restoring the region's democratic transformation.

The tools Russia has used to expand its presence in the region are not new: political pressure; soft power, including cultural, media, and religious campaigns; and economic leverage ranging from the control and acquisition of critical energy assets to the financing of political parties and media. These tools are underpinned by a concerted Kremlin narrative designed to counter Euro-Atlantic values.² The seeds of this narrative have landed on fertile ground in the Western Balkans, where a climate of unstable institutions of governance and rule of law, and protracted and systemic corruption at both the administrative and political levels, often lead to policy, regulatory or even state capture. The mixture of weak institutions of rule of law and kleptocratic tendencies, media propaganda and geopolitical pressure from Russia (as well as from other countries), has led many Western Balkan governments to adopt policies inconsistent with their national security or development interests. This situation calls for a better understanding and re-assessment of the political and economic factors that threaten the region's development now, and in the future.

¹ For a more complete definition, see Wilson, Andrew. (2018). “Closing Governance Gaps to Promote Resilient Economies in the Balkans”. CIPE Development Blog. January 18, 2018, accessed on January 25, 2018 at <http://www.cipe.org/blog/2018/01/18/closing-governance-gaps-to-promote-resilient-economies-in-the-balkans/#.WmmFriOB3UY>

² For a comprehensive analysis of the Russian strategic rationale in the region see Bechev, Dimitar. (2017). “Rival Power: Russia in Southeast Europe”. Yale University Press, October 3, 2017.

In order to better understand the size, scope and potential effects of Russian corrosive capital in the Western Balkans, this paper analyzes Russia's economic footprint from 2005 to 2016 in four countries in the region: Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia. The analysis outlines the ways in which Russia's economic presence can be linked to the cultivation of an opaque web of economic and political patronage across the region – a web that undermines economic and democratic development by influencing decision-making in the critical areas of energy and foreign policy.³

³ For a similar in-depth analysis of Russia's impact on Central and Eastern Europe see Conley, H., Mina, J., Stefanov, R., Vladimirov, M. (2016). "The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe". Center for Strategic and International Studies, accessed on January 25, 2018 at <http://www.csd.bg/artShow.php?id=17805>

METHODOLOGICAL NOTES

The current report explores the size, dynamics and effects of Russia's economic footprint in the Western Balkans, and in particular in Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia. The report seeks to analyze whether Russia has used or tried to leverage corrosive capital in the region. The report traces Russia's economic footprint in the region after 2005. The economic footprint has been broken down into three indicators:

- Corporate footprint: the share by percentage of the turnover of Russian-controlled companies (by final beneficial owner) of the total turnover of the economy;
- Foreign direct investment: share by percentage of Russia's FDI stock of the GDP of the country; and
- Bilateral trade: Russia's share by percentage of the total exports and total imports of the country (with a focus on oil and gas).

The corporate footprint analysis includes companies with at least 10 percent Russian ultimate beneficial ownership and annual revenues of at least EUR 250,000 (~USD 310,000). It should be noted that while the study has endeavored to identify final beneficial owners, some of the largest companies active in the region may ultimately be controlled by a Russian owner, but are not registered as so, due to opaque ownership structures through offshore jurisdictions or shell structures. Confirming the Russia origins of some companies required detailed additional investigation. Besides the size of the corporate presence, in certain notable cases, the study explores the subsidiary tree of ownership to evaluate the depth and reach of these companies' footprint in the local economy. This included the impact of the largest of the identified companies in the structure of the specific sector; the indirect economic influence of these companies via their trade and investment partnerships with local subsidiaries, distributors, suppliers and contractors; and market concentration.

Special emphasis has been placed on Russian investment in key sectors critical for the whole economy, such as energy, finance, metallurgy, construction, transportation and real estate. To assess the potential corrosive capital effect of such investment, the report investigates the pattern of acquisition of control over critical assets, how gaining control of such assets has changed the structure of the market, and whether market concentration has preceded or followed such acquisitions.

Apart from presenting the dynamics of the overall trade balance, where possible, the analysis traces economic exposure to Russia by sector, especially in vital areas such as energy, manufacturing, chemicals, and so on. Trade relations have been analyzed to uncover persistent dependencies in the value chain, such as in oil and gas, and the potential impact of

an energy supply disruption. Energy security and governance risks are showcased in the example of Russia-backed, large-scale infrastructure projects.

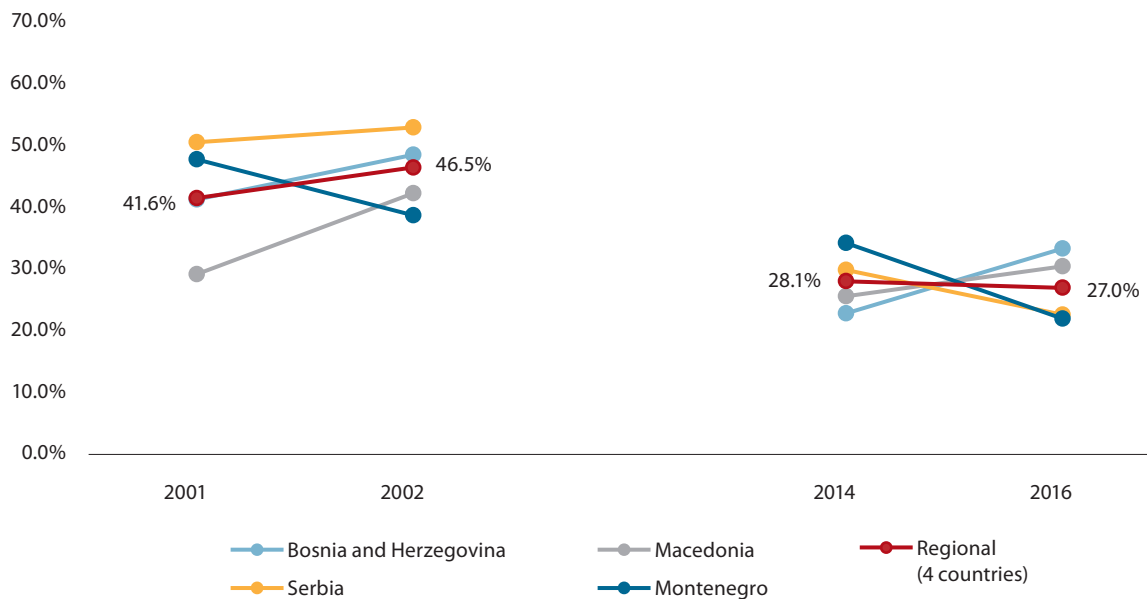
The study's findings have been based on: (1) publicly-available data from national statistics, commercial registries and the stock market; (2) detailed information obtained through a network of experts in the region; and (3) in-depth media content research in key economic sectors of the particular country. Because of the nature of some aspects of the external economic presence, certain assumptions and approximations have been made, which are clearly stated in the text.

REGIONAL GOVERNANCE GAPS: DOWN, NOT OUT

The countries of the Western Balkans suffer from high levels of corruption that, in some cases, have resulted in the capture of policies, regulatory functions, and even the state. Consequently, popular trust in politicians, political appointees, and public institutions has diminished, contributing to conditions that are already ripe for external actors to try to influence events in the region.⁴

Although all countries in the region saw significant declines in corruption pressure,⁵ by an average of 15 percentage points, levels remain higher than those seen in the EU. These dynamics within countries have also changed. While Serbia and Montenegro have dropped below the regional average, corruption pressure in Macedonia now exceeds the

Figure 1. Corruption Pressure in the Western Balkans Region



Source: SELDI.

⁴ SELDI. (2014). "Anticorruption Reloaded: Assessment of Southeast Europe". Center for the Study of Democracy, November 12, 2014, accessed on January 25, 2018 at: <http://seldi.net/publications/publications/anti-corruption-reloaded-assessment-of-southeast-europe/>

⁵ Corruption pressure is an indicator of the Corruption Monitoring System of the Center for the Study of Democracy. It denotes the share of the population that has been asked to give a bribe or participate in other forms of corruption. For more information on CMS, please see SELDI. (2014). "Anticorruption Reloaded: Assessing Corruption and Anti-Corruption in Southeast Europe". Center for the Study of Democracy, November 12, 2014, accessed on January 25, 2018 at: <http://seldi.net/publications/publications/anti-corruption-reloaded-assessment-of-southeast-europe/>

average; Bosnia and Herzegovina has experienced higher than average levels throughout the past two decades.⁶

The EU’s annual progress reports identify clear gaps in regional governance. The reports, which rank the countries of the Western Balkans only a notch above rudimentary levels of governance, have been met by a backlash in the region – in turn spurring political elites to seek opportunities for development that are not linked to better governance. As a result, alternatives to the EU development narrative are now receiving greater attention throughout the region. These alternatives seek to play down, and even disregard, the positive impact of the EU. The Kremlin, which is one proponent of such alternatives, promotes these alternative narratives through its media presence.

Figure 2. EU Assessment of Anti-Corruption State and Progress in the Region (2016)

Report Area	Anticorruption				
	Montenegro	Serbia	Macedonia	Bosnia and Herzegovina	
Country					
State of play					
Early stage					
Some level of preparation					
Moderately prepared					
Good level of preparation					
Well advanced					
Progress					
Backsliding					
No progress					
Some progress					
Good progress					
Very good progress					

Source: CSD based on European Commission Progress Reports.

⁶ SELDI. (2016). "Shadow Power: Assessing Corruption and Hidden Economy in Southeast Europe". Center for the Study of Democracy, November 12, 2014, accessed on January 25, 2018 at: <http://seldi.net/publications/publications/shadow-power-assessment-of-corruption-and-hidden-economy-in-southeast-europe/>

RUSSIA'S ECONOMIC FOOTPRINT: SIZE AND WHY IT MATTERS

Russia's economic footprint in the Western Balkans has shrunk or stagnated in the wake of an economic recession and international sanctions over the annexation of Crimea. Because Russian businesses are concentrated in a small number of strategic sectors however – such as banking, energy, metallurgy and real estate – the four small, energy-dependent countries assessed in this report remain vulnerable to Russian pressure. An overreliance on Russian imports, coupled with an expansion of Russian capital, has made the governments of the Western Balkans particularly susceptible to pressures on strategic decisions related not only to energy market diversification and liberalization, but also to Russian sanctions, and NATO and EU expansion.

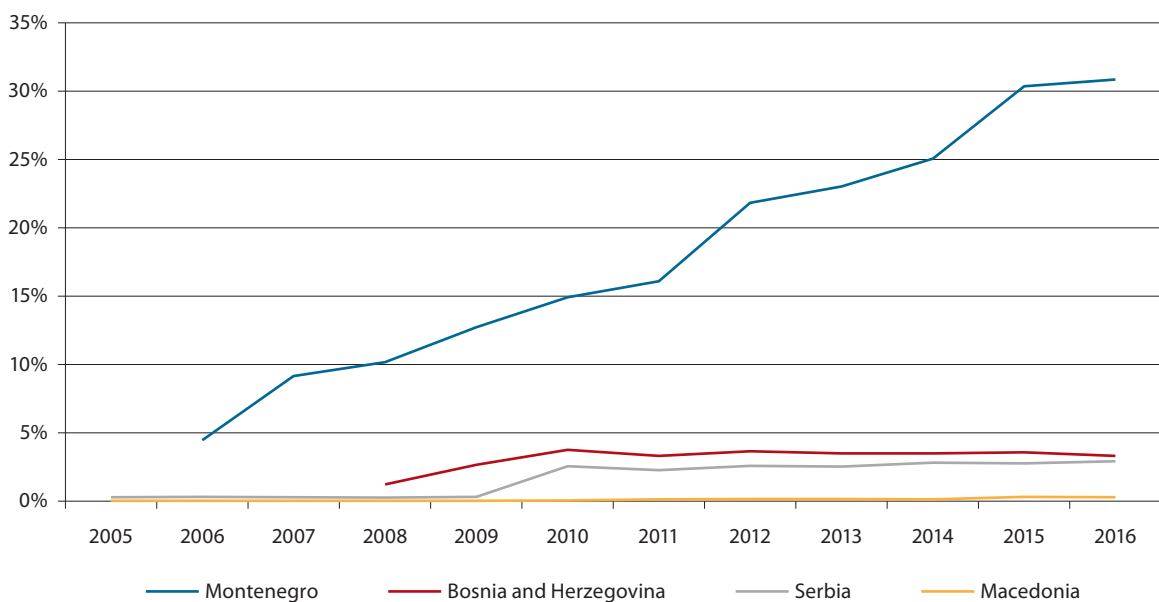
Local kleptocratic networks also have leverage over the administrations of the Western Balkan through links to Russia-based entities, such as businesses, media outlets and non-profit organizations. Such networks take advantage of Russian ties in the energy sector to amass wealth that they then invest in other sectors of the economy, such as banking, mining and real estate. Once leverage is established, these local networks can slow or limit the liberalization of energy markets and the diversification of sources of oil and gas. They can dilute oversight of bank loans, strategic mergers and acquisitions, and government-to-government agreements. They can even shape outcomes tantamount to state capture. Because Russia and local kleptocratic networks represent long-term threats to sustainable economic growth in the region, they also threaten the strength of democratic institutions. This form of state capture-driven economic presence would not be so problematic for the countries of the Western Balkans if it were not for the Kremlin's high-profile crackdown on the Russian private sector. The resulting state-private networks are no longer simply tools for personal enrichment and economic opportunism, but also instruments of concerted political influence.

The impact of Russia's economic footprint has been underestimated by the US and governments of the EU, resulting in a failure to recognize the true extent of the associated risks. In the Western Balkans, for example, the impact of Russian foreign direct investment (FDI) has been downplayed, due to a variety of factors. First, Russian FDI has been likened to the EU's total FDI stock, without taking into account that the EU, unlike Russia, is not a singular entity; FDI originating from an individual EU country does not necessarily reflect common economic policy. Second, Russian FDI channeled through offshore zones and tax havens such as Cyprus remains largely hidden, which means that countries on the receiving side are not necessarily prepared for the potentially negative effects on governance. Third, the Russian government's ability to use FDI as a foreign policy tool has been overlooked; no EU member country can compete with Russia in the speed and scope of

control over its corporate citizenry. Finally, Russian companies in the Western Balkans focus primarily on strategic sectors such as energy, fuel processing, and banking, whereas the investment portfolios of EU countries are more diversified, including manufacturing, retail trade, and telecommunications.

Data shows that Russia’s economic footprint in the Western Balkans is most pronounced in Montenegro, where Russian FDI constitutes nearly 30 percent of the country’s gross domestic product (GDP). Russia’s footprint is least pronounced in Macedonia, where Russian FDI tops out at only one percent of GDP. The footprint is about equal in Bosnia and Herzegovina and Serbia: Russia exerts direct and indirect control over about 10 percent of the economy of Serbia, primarily in key sectors such as energy and banking, and accounts for more than eight percent of FDI in Bosnia and Herzegovina – down from an all-time high of 9.8 percent in 2010. (Russia’s corporate presence is felt unequally in the country’s two entities, the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS). Russian FDI is concentrated in RS, where in 2014 – the year in which the latest data is available⁷ – Russian-owned companies controlled 39 percent of the total corporate turnover in the hands of foreign companies operating in all of Bosnia and Herzegovina.

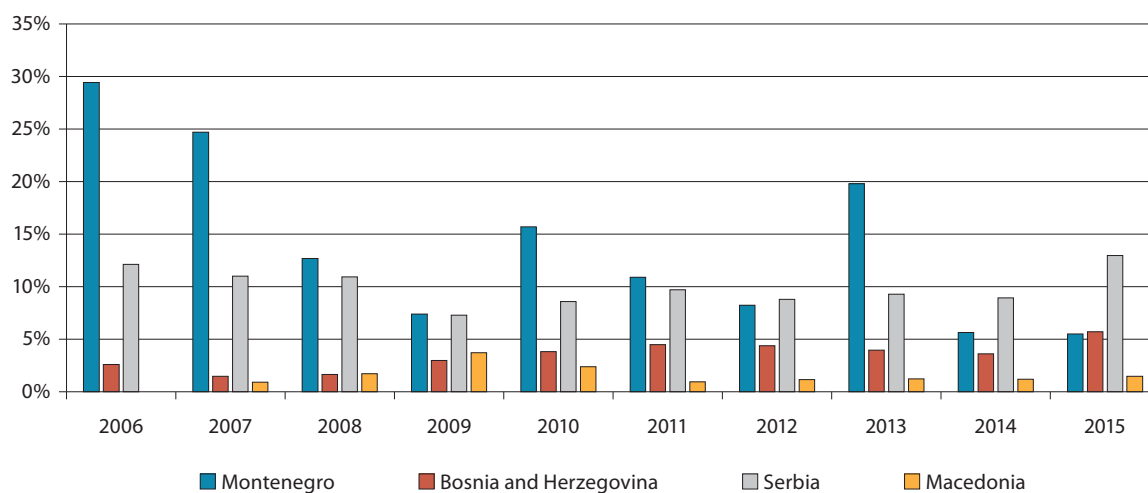
Figure 3. Russian FDI Stock as Share of GDP (%)



Source: CSD calculations based on national central banks and UNCTAD country statistics.

⁷ Turnover is defined as revenue calculated from sales of products, goods and services by the reporting unit to third parties during the reference period, excluding deductible value-added tax (VAT). Financial and extraordinary revenues are excluded.

Figure 4. Russian Revenues as Share of Total Revenues in Western Balkan Economies*



* Data for Macedonia was unavailable for 2006, but analysis shows Russian revenue was marginal.

Source: CSD calculations based on commercial corporate databases.

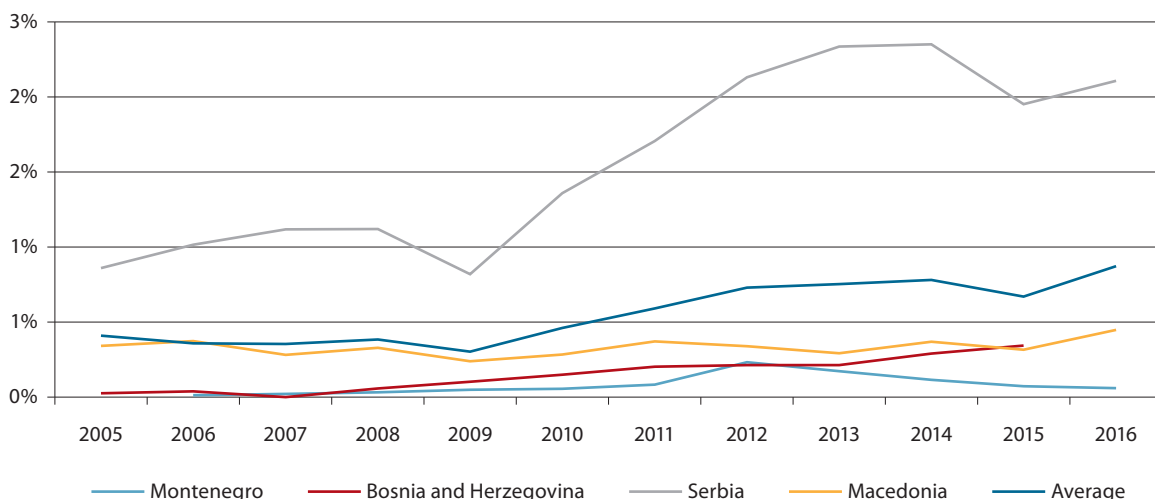
As seen in Figure 4, revenue for Russian companies as a share of total turnover in the Western Balkans has remained relatively stagnant, and in some cases even declined from 2011 to 2015. In Montenegro, revenue declined from 29.4 percent in 2006 to around 5.5 percent in 2015. This trend is echoed in the workforce of Russian-controlled companies in Montenegro: employment fell from 14.2 percent in 2007 to 5.5 percent in 2015. The rapid decline of Russia's economic presence in Montenegro can be traced to the withdrawal of Russian metallurgy tycoon Oleg Deripaska from Montenegro's largest company in 2012 – 2013, the Podgorica Aluminum Plant (KAP) – which formerly accounted for 2.3 percent of the country's total labor force, about 15 percent of its GDP, and some 51 percent of its exports. Russian control over KAP had also given Russia economic leverage over Montenegro's national power company, the Montenegrin Electric Enterprise (EPCG), to which KAP became heavily indebted while under Russian control. Deripaska's entry into Montenegro in 2006 also opened the door to feverish Russian investment in the real estate and tourism industries, leading to plans for a series of multi-million-dollar resorts along the Montenegrin coast.⁸ Over the past decade, Russia has been the single largest direct investor in Montenegro, with USD 1.27 billion in cumulative investments, or about 13 percent of total FDI stock. In 2016, one-third of the foreign firms in the country, or 1,723, were owned by Russian nationals,⁹ according to data from the Montenegro corporate registry.

⁸ Ames, Mark and Berman, Ari. (2008). "McCain's Kremlin Ties". The Nation. October 1, 2008, accessed on December 4, 2017 at <https://www.thenation.com/article/mccains-kremlin-ties/>

⁹ Structural business and foreign affiliate's data as reported by the Montenegrin Statistical Office at <http://www.monstat.org/eng/page.php?id=67&pageid=67>

In Serbia, over the same ten-year period, Russia’s corporate presence remained relatively constant at around 10 percent of the economy, and is concentrated primarily in the energy sector. Overall Russian FDI in Serbia has remained small, comprising four percent of the total FDI stock, or in absolute numbers, around USD 1.1 billion. This figure, however, underestimates the true value of Russian investment in the country. In reality, much of Russian FDI in Serbia comes through Russian-owned companies with offices in EU member states, such as Austria and the Netherlands. The Serbian oil and gas company, Naftna industrija Srbije (NIS), has invested alone at least USD one billion to upgrade its refinery in Pančevo since Gazprom, Russia’s state-owned major, purchased the company in 2008. The Russian oil and gas company Lukoil has invested another USD 250 million in the wholesale fuel distribution market. Therefore, a more realistic estimate of total Russian FDI – including indirect investment – would be around USD two billion, or six percent of Serbia’s GDP.

Figure 5. Exports to Russia as Share of GDP (%)



Source: CSD calculations based on trade statistics from EUROSTAT’s COMEXT database.

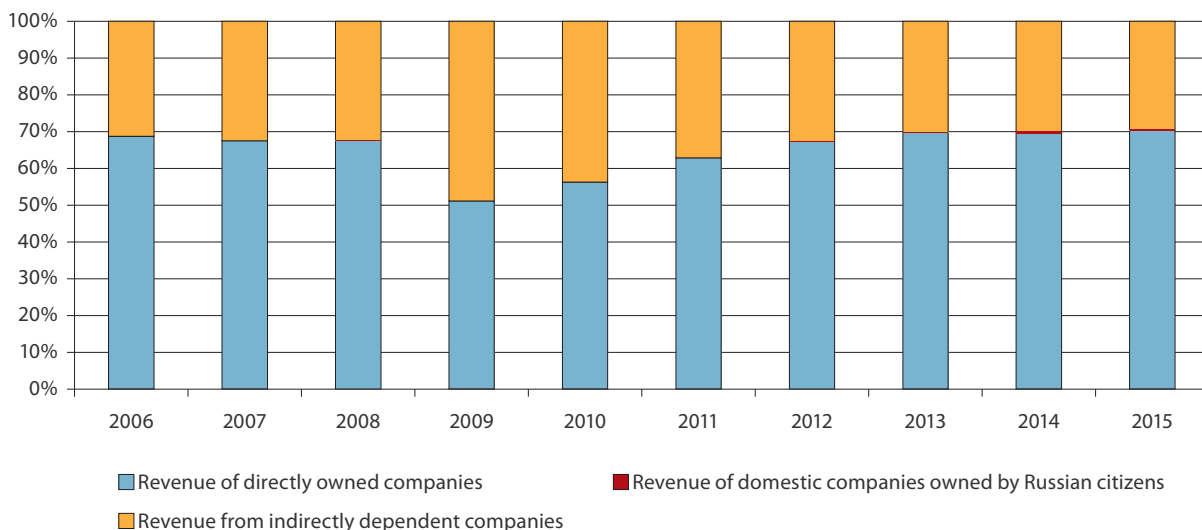
Russia has expanded its presence in the Serbian economy through not only corporate investment, but also via direct government-to-government loans. During the Serbian fiscal crisis in 2012 – 2013, Serbia asked Moscow for a loan to buttress the Serbian budget. This could be read as an effort to avoid asking for assistance from the International Monetary Fund (IMF), which would have required structural reforms. Russia agreed to lend Serbia USD 500 million and disbursed USD 300 million immediately to keep the country afloat. At the same time, Serbia borrowed an additional USD 800 million from Moscow to modernize the country’s outdated railway infrastructure. At an annual interest rate of 4.1 percent, the Russia loan had less favorable conditions than typical loans from European development financial institutions such as the European Bank for

Reconstruction and Development (EBRD) and the European Investment Bank (EIB). Moreover, the second loan granted preferential status to Russian state-owned contractors for infrastructure modernization projects.¹⁰ This loan was not debated publically, and it seems that Serbia agreed to the terms of exclusive access for Russian contractors in violation of EU norms on competition and transparency in public procurement.

Moreover, the negotiations for the loan coincided with negotiations between Gazprom and Srbijagas over a ten-year supply of gas. The resulting agreement called for the annual delivery of up to five billion cubic meters (bcm) of natural gas from Russia, more than double the Serbian demand. Serbia must purchase no less than 1.5 bcm¹¹ of natural gas from Russia each year, according to media sources, as well as interviews with sources close to Srbijagas.

Russia's economic footprint in Serbia is not limited to the energy sector. In fact, Russia's greatest presence can be seen in the corporate arena. Approximately 1,000 companies in Serbia are entirely, or partially, Russian-owned.¹² These companies control revenues of about EUR five billion, or some 13 percent of the total revenue generated by the domestic economy. As described below, the indirect footprint of Russian companies goes

Figure 6. Structure of Russian Corporate Presence in Serbia



Source: CSD calculations based on a commercial corporate database.

¹⁰ For example, in June 2017, the German development bank, KfW, lent Serbia EUR 17 million for new water supply infrastructure. See <https://seenews.com/news/serbia-gets-17-mln-euro-loan-from-kfw-for-water-supply-projects-571661>

¹¹ Blic. (2017). Miller: NIS will invest up to EUR three billion. March 27, 2013 as reprinted from Tanjug, accessed December 6, 2017 at <http://www.blic.rs/vesti/ekonomija/miler-nis-ce-investirati-vise-do-tri-milijarde-evra/vtv6qlt>. Serbia imported close to 1.8 bcm of natural gas from Russia in 2016. Domestic production was around 400 million cubic meters.

¹² According to a corporate database analysis.

through several channels, including: (1) the dependence of local companies on imports of Russian raw materials such as natural gas; (2) debts accumulated for gas supply; and (3) the dependence of domestic companies on exports to Russia or loans provided by Russian-controlled banks, for example the subsidiaries of Agrokor.

Meanwhile, the scope of assets directly or indirectly under Russian control has hovered between eight and 10 percent of total assets in the Serbian economy. This is despite the below-market rate valuation of NIS's oil and gas reserves, and the decapitalization of some petrochemical plants, the gas debts of which have been transformed into equity for Gazprom. Russian state-owned and private oil and gas companies own almost all domestic oil and gas reserves, control over 50 percent of the wholesale and retail fuels markets, and indirectly influence the financial management and corporate governance of state-owned gas supplier Srbijagas, as well as the supplier's major industrial clients. Moreover, Russian companies employ around two percent of the total labor force directly and around five percent indirectly, or around 70,000 people, primarily in a small number of industrial enterprises such as NIS, Beopetrol/Lukoil, Sberbank, and Srbijagas-related petrochemical and glass-making plants.

In Bosnia and Herzegovina, Russia's economic footprint is seen primarily in the oil and gas sectors. Even though the country imports some oil from Croatia and Serbia, Bosnia and Herzegovina is fully dependent on Russian gas: Russian companies control the country's two refineries, both of which are located in RS. Over the past decade, the corporate footprint of Russian companies has more than doubled in the country, growing from 2.6 percent of total revenue in 2006 to 5.7 percent in 2015. In absolute figures, Russian companies accounted for a turnover of around EUR one billion in 2016. The concentration of Russian investment and companies in RS reflects the wariness of EU-based companies about investing in the constituent state: widespread corruption means substantial corruption-related costs. In 2016, the share of Russian firms in the economy of RS reached more than eight percent; Russian companies have been by far the biggest investors since the 2008 economic crisis diminished the interest of Western investors in this frontier market.

In Bosnia and Herzegovina, the level of Russian FDI has increased from as low as USD 235 million¹³ in 2008 to around USD 547 million in 2016, or 8.1 percent of the country's total FDI stock (and 3.3 percent of its GDP). Most Russian investment is concentrated in oil processing, fuel and gas distribution, and financial services. This, however, does not include purported direct government loans from Russia to RS. The President of RS was reported to have negotiated a EUR 270 million loan from Moscow in April 2014, in an attempt to push the state government to abandon a previous agreement with the International Monetary Fund (IMF). It implied that structural reforms¹⁴ were impossible to implement due to

¹³ FDI statistics before 2008 were not available.

¹⁴ Latal, Srecko (2016). "Bosnia Clinches New €550m Deal With IMF," *BalkanInsight*. May 25, 2016.

a lack of political consensus among the political parties.¹⁵ Months later, President Dodik said that Russia had pledged between EUR 500 and 700 million, which would cover the government's expenditures in case the IMF did not disburse a new loan following the expiration of the Fund's lending agreement in 2015.¹⁶ There were, however, no reports confirming the actual disbursement of these Russian funds.

In October 2015, President Dodik discussed a USD 300 million loan to finance the entity's budget deficits in 2015 and 2016 from a California-based investment fund called Global Bancorp Commodities and Investments, Inc. (GBCI), implementing waste management technologies in Russia. According to several media sources, this company is also linked to a Russian citizen – Alexander Vassilev.¹⁷ The loan negotiations with Russia came only a few months after the country was hit with devastating floods that paralyzed the economy and left authorities with little cash. Again, no reports ever confirmed that this loan materialized. The terms of the potential loan also remained confidential, not only to the public but also to relevant government institutions, as the loan was not discussed in public or in the Parliament of RS.

Virtually no information about the bridge loan or its conditions is available, and the loan was negotiated behind closed doors. The lack of transparency, let alone a publically available cost-benefit analysis, contributed to some suspicion that political considerations motivated the agreement. Indeed, the exchange fits a pattern of Russian deals with other states, such as the 2013 loan agreement with Ukraine that provided a USD three billion financial lifeline to former President Viktor Yanukovich in exchange for cancelling the Association Agreement with the EU.¹⁸

Among the four Western Balkan countries, Russia's economic footprint in Macedonia is often seen as limited, or even non-existent. However, a detailed assessment of Russia's presence in the country reveals a more nuanced picture, in which the channels for influence are indirect – hidden behind a network of offshore companies, or third parties located in the EU. Former Prime Minister Nikola Gruevski and his ruling coalition were keen on strengthening economic ties with Russia, especially in terms of cooperation on large-scale natural gas projects such as the now-defunct South Stream pipeline and its successor, TurkStream. However, reality has yet to reflect these ambitions in Macedonia. Trade turnover between the two countries remains minimal, though it rose after 2014, as Macedonian agricultural producers benefitted from the Russian embargo on EU farmers. Macedonia also refused to join the EU- and US-led sanctions against Russia after the annexation of Crimea, citing potential damage to its exports to Russia. In absolute figures, trade turnover between the two coun-

¹⁵ Jukic, Elvira (2014). "Bosnian Serbs Seek Russian Loan to Replace IMF," *BalkanInsight*, April 3, 2014.

¹⁶ "Bosnian Serb leader says Russia will loan region 500-700 mln euros," *Reuters*. September 19, 2014.

¹⁷ Mukova, Denitsa (2015). "Mystery investor lends \$300mn to Republika Srpska," October 16, 2015.

¹⁸ Walker, Shaun. (2013). "Vladimir Putin offers Ukraine financial incentives to stick with Russia," *Guardian*, December 18, 2013.

tries has never exceeded EUR 400 million, and currently is around EUR 100 million.

Similarly, Russian direct investment in Macedonia is insignificant at USD 30 million in 2015, although this number is an increase from a starting point of almost zero in 2009. Instead, Russian businesses have invested indirectly, using offshore destinations such as Cyprus, Belize, or countries with preferential tax regimes such as the Netherlands, where Lukoil, the largest Russian company in Macedonia, is registered. Indirect investment becomes more visible when reviewing data from companies that have an ultimate beneficial owner, an entity or a person, located in Russia. One example is the sports and betting business created by Russian businessman Sergey Samsonenko, who became one of the wealthiest individuals in the country and openly supported Gruevski's pre-election campaign (See Box 1).

The analysis showed 78 companies registered in Macedonia with at least 25 percent Russian ownership. The revenues of Russian companies operating in Macedonia have grown fourfold, from EUR 63 million in 2006 to over EUR 212 million in 2015. Still, they make up a little over one percent of the total revenues in the economy, with close to half of the sales generated by one company – the retail fuel distributor Lukoil – while the other half is concentrated in the two gas pipeline construction companies building the expanded gas distribution network, as well as Samsonenko's betting companies.

In comparison, Macedonian companies with Austrian and Dutch ultimate beneficial ownership controlled more than 26 percent of the total revenues of all businesses in the country and 24 percent of the total assets in the economy, and employed 15 percent of the labor force. Greek companies make up another 13 percent of the economy, with refinery operator Hellenic Petroleum as the largest Greek investor. Among these companies are also some of the largest in the country, such as the power distribution provider EVN and the Kavadarci ferronickel plant, owned by the largest nickel producer in Europe, Cunico Resources, which is registered in the Netherlands. With its significant stake in the banking, fuel distribution and shipping sectors, Greece seems to have the largest corporate presence in the country. However, it should be noted that the mining company Solvay, which operates lead, zinc, and copper mines in the country, as well as the joint venture owning and operating the TE-TO Combined Cycle Heat and Power Plant near Skopje, are owned by offshore entities linked to Russian holdings. They do not appear directly Russian-owned.¹⁹ but including them would almost double the Russian economic presence in Macedonia, though Russia's presence would still remain marginal compared to that of Greek, Austrian and Dutch companies.

¹⁹ Fomicheva, Anastasiya. (2015). "Sorry, Skopje: TKG-2 lost the right to a 100 % ownership of the TPP in Macedonia," *Kommersant*, October 14, 2015, <https://www.kommersant.ru/doc/2832233>

EXPLOITING GOVERNANCE DEFICITS IN VULNERABLE SECTORS

Energy

The most visible manifestation of Russia's growing economic footprint in the Western Balkans can be seen in the gradual takeover of the energy sector by Russian companies. In Serbia, Russia has taken advantage of ineffective governance in key sectors of the economy to expand its footprint. Its investments in the energy sector specifically have been designed to reduce competition and reinforce Russia's position by locking in supply. Such investments are designed not only to protect Russia's economic and political interests, but also to promote interdependence among countries that prioritize Russia in their relations. In both Serbia and Bosnia and Herzegovina, the management of state-owned gas companies lacks transparency. Even though long-term contracts with Gazprom have kept gas import prices higher than in most European countries, the energy ministries in Serbia and Bosnia and Herzegovina have not tried to restructure these agreements to allow for more flexibility. Moreover, the ministries have done little to accelerate diversification projects in strategic gas supply. Policymakers, meanwhile, have publicly defended large-scale, Russian-led gas infrastructure projects – such as South Stream and TESLA – without proper cost-benefit analysis, instead making fanciful promises of new jobs and economic growth. Intergovernmental agreements for these projects have been negotiated in complete secrecy, raising suspicions that the deals contain terms locking in the countries' long-term gas supply.

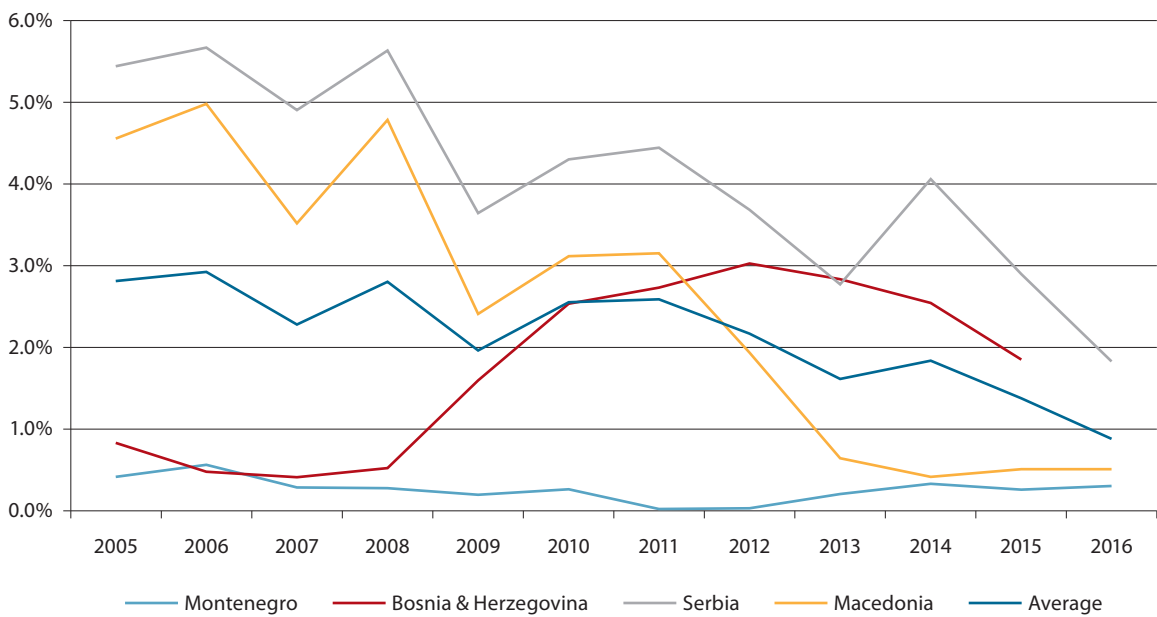
In both Serbia and Bosnia and Herzegovina, the now-abandoned South Stream gas pipeline project was managed in violation of the EU Third Energy Package, because Gazprom owned more than 50 percent of the project company. (The Package's unbundling rule states that the owner of the natural gas cannot also own a majority stake in the transmission network.) In addition, gas companies in both countries have not yet been restructured fully, in line with the "energy acquis," or legal framework of the Energy Community. As noted in the 2017 Energy Community progress report, the gas markets in Serbia and Bosnia and Herzegovina are highly concentrated and largely closed.²⁰

Energy trade has been a common denominator in the persistent trade deficits of Bosnia and Herzegovina, Macedonia, and Serbia. In all three countries, crude oil and natural gas comprise between 75 and 95 percent of imports from Russia. Such energy dependence has contributed to the countries' overall trade vulnerability, which – as seen in the case of Ser-

²⁰ European Energy Community (2017). Annual Implementation Report. September 1, 2017, Energy Community Secretariat.

bia’s gas disputes with Russia – can lead to supply cuts, corporate raids of large industrial assets, and acute foreign policy pressures. The combination of energy debts and unfavorable contracts stunts economic growth and fiscal stability, in turn pressuring governments to yield to political demands. While the influence of this tool has declined in the past decade, most notably because of the decline in energy processing, it nonetheless persists as Southeastern Europe remains the most fragmented and isolated part of Europe in terms of energy.

Figure 7. Oil & Gas Imports as Shares of GDP (%)



Source: CSD calculations based on trade statistics from EUROSTAT’s COMEXT database.

Across the Western Balkans, Russia has targeted large, non-reformed (in terms of corporate governance) state-owned companies that are dependent on a handful of managers and political appointees susceptible to manipulation by Russian state and private entities. Gazprom has solidified its dominance over the domestic natural gas markets in Bosnia and Herzegovina, Macedonia and Serbia by striking inflexible long-term gas supply agreements; promoting large-scale, expensive gas pipelines; installing domestic gas intermediaries with strong political connections; and blocking attempts at liberalization of the market and the diversification of sources of energy. In 2008, Gazprom’s oil subsidiary Gazpromneft purchased Serbian oil and gas holding NIS, the largest Serbian company, following a non-transparent intergovernmental agreement with controversial terms. The 2008 agreement contained a provision that Serbia would take part in the now-abandoned South Stream gas pipeline project, which would have cemented the country’s gas dependence on Russia. The deal can be linked to Russia’s support for Serbia’s rejection in

February 2008 of Kosovo's bid for unilateral independence. This nexus of energy and geopolitics has been the bedrock of Russia's influence in the Western Balkans, serving as a breeding ground for a multitude of activities geared toward expanding Russia's economic presence in banking, mining and real estate.

Instead of seeking to diversify their gas supplies through natural gas interconnectors with Bulgaria and Croatia, the countries of the Western Balkans (except for Montenegro, which does not consume gas) have remained energy islands that devote most of their political efforts to promoting Gazprom-led pipelines. Unsurprisingly, Bosnia and Herzegovina and Macedonia – which have failed to liberalize their gas markets, and rely on fixed, oil-indexed, long-term contracts – pay some of the highest prices²¹ for gas in Europe.

In Serbia, the high prices charged by Gazprom, coupled with the lack of flexibility in the company's long-term deal with wholesale Serbian gas supplier Srbijagas led the latter to amass EUR 200 million in debt between 2001 and 2011 for unpaid natural gas supplies. The losses are a result of the mismatch between the high prices of gas imports and the domestic prices for consumers, which the Serbian regulator kept artificially low in order to prevent social unrest. Moreover, Srbijagas has been unable to collect from several large state-owned enterprises (including the Azotara fertilizer plant, the Petrohemija petrochemical plants, and the Smederevo steel mill), as well as municipal district heating companies. A considerable part of Serbian heavy industry depends on a supply of cheap natural gas, both from Srbijagas and domestic sources exploited by NIS. However, once the global economic crisis hit in 2009, large Serbian businesses began defaulting on their gas debts, prompting their takeover by Srbijagas and the state. On principle, successive Serbian governments have refused to restructure or close loss-making state companies, fearing social and political blowback. Under IMF pressure, the government of Prime Minister Aleksandar Vucic has begun to address these structural problems. The aforementioned companies represent some of the biggest Serbian exporters. Yet their profitability depends on the availability of cheap natural gas and fuels.

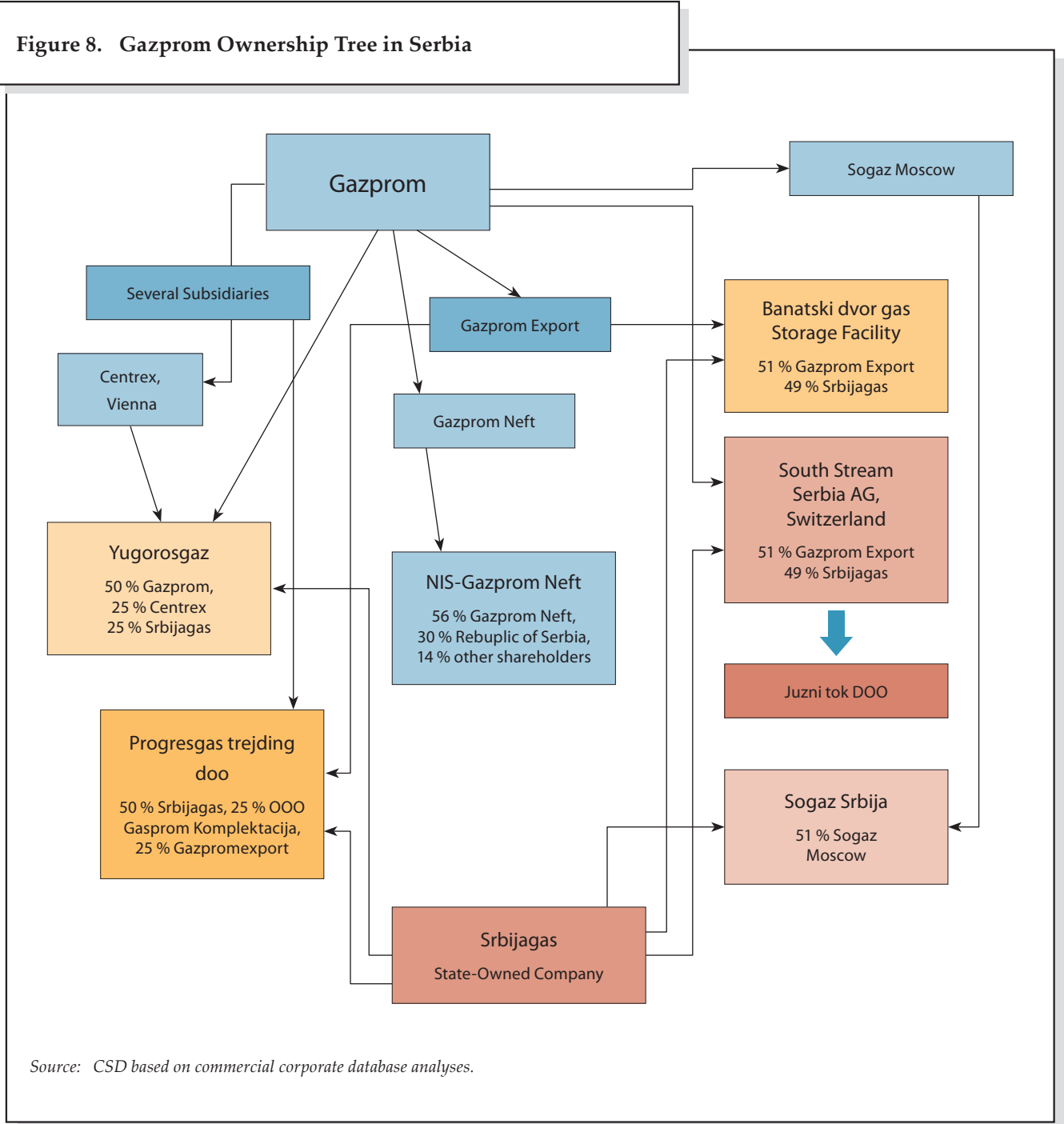
When gas prices began rising in the mid-2000s, Azotara, Petrohemija and Smederevo – in light of scant alternatives to Gazprom – began defaulting on their gas debts. For example, Azotara Fertilizer Plant, Petrohemija and Smederevo Steel Mill, which are not owned by Srbijagas or the state, amassed huge losses from 2008 to 2014, despite receiving cheaper natural gas from Srbijagas.²² It is in the strategic interest of Gazprom for all three companies to survive, since they constitute almost one-third of Serbia's gas market. Gazprom may avoid purchasing these companies outright, and instead leverage their debt to pressure Serbia, since the indebted com-

²¹ Gazprom's Grip: Russia's Leverage Over Europe. Radio Free Europe – Infographics on the Russian gas dependence in Europe by country, accessed on November 9, 2017 at <https://www.rferl.org/a/gazprom-russia-gas-leverage-europe/25441983.html>

²² Republic of Serbia – Fiscal Council. Assessment of State-Owned Enterprises in Serbia: Fiscal Aspects. Belgrade: July 31, 2014, accessed on January 22, 2018 at http://www.fiskalnisa.gov.rs/doc/eng/analysis_of_state-owned_enterprises-fiscal_aspect.pdf

panies' potential collapse could leave thousands of workers on the street protesting.

Figure 8. Gazprom Ownership Tree in Serbia



Source: CSD based on commercial corporate database analyses.

Gazprom has already exploited Serbia's vulnerability by cutting gas deliveries. The most significant manipulation of the gas supply – a 30 percent reduction – occurred mere days before Russian President Vladimir Putin's visit to Belgrade in 2014. At the time, Gazprom cited Srbijagas debt as the reason for the cut.²³ In March 2016, Srbijagas began talks to re-

²³ "Russia Reduces Gas Flow to Serbia over Unpaid Debt," *Novinite.com*, November 1, 2014, <http://www.novinite.com/articles/164467/Russia+Reduces+Gas+Flow+to+Serbia+over+Unpaid+Debt>

structure its total debt, which was worth around EUR one billion – about half of which was owed to Russian state-owned banks. The Serbian state took over the majority of the debt owed directly to Gazprom, which the country's worsening fiscal position now reflects.

Srbijagas's difficult financial position is one of the main reasons why the Serbian government has been reluctant to unbundle the company in accordance with the rules outline in the EU's Third Energy Package. If Srbijagas loses its transmission and gas storage operations and becomes just a distribution company, it might go bankrupt. Serbs close to Gazprom, such as Dusan Bajatovic, CEO of Srbijagas, who is also a member of the board of directors of the Gazprom subsidiary Yugorosgaz, have opposed the restructuring of Srbijagas: such a move would not only bring more transparency to the gas sector, but increase competition from independent suppliers. By objecting to the restructuring of Srbijagas, Bajatovic has thwarted progress on the interconnector project, because EBRD demanded Serbia's alignment with the Third Energy Package, which requires that the ownership of supply and transmission activities be legally and functionally separated. He has also readily defended Gazprom's interests in the media, and has publicly opposed, among other issues, an attempt to increase the mining tax.

Moreover, Bajatovic – deputy head of the Socialist Party of Serbia (SPS), a junior coalition partner of the current Serbian government – has represented Serbia in most joint ventures with Gazprom, including South Stream, Sogaz, the joint Serbian-Russian insurance company, and Banatski Dvor, the underground gas storage facility built by Gazprom. His appointments to the senior management of these companies would appear to contradict the OECD's best practices in corporate governance, which recommend clear separation between politics and the management of national companies, in order to prevent conflicts of interest, clientelism, and unprofessionalism.²⁴ From his positions, Bajatovic receives around EUR 20,000 per month,²⁵ which is 20 times more than his baseline reported income from Srbijagas. Because of Srbijagas' sponsorship, he is also the President of the board of directors of the Sport Society Vojvodina, an association of sport clubs from Novi Sad, and was a member of the board of directors of one of two biggest football clubs in Serbia, Crvena Zvezda, whose main sponsor is Gazprom. The Anti-Corruption Agency recommended in 2014 that Bajatovic resign from the post of CEO, but he managed to defy the recommendation.²⁶ In the media, he often promotes cooperation with Russia in the energy sector and criticizes all other energy diversification options, including the interconnector with Bulgaria and any potential supply from a liquefied natural gas terminal on Krk in Croatia.²⁷

²⁴ OECD. (2015). OECD Guidelines on Corporate Governance of State-Owned Enterprises. Edition 2015, accessible and downloadable at <http://www.oecd.org/corporate/guidelines-corporate-governance-SOEs.html>

²⁵ Nataša Latković "Srbijagas" u sve većoj dubiozi, a Bajatoviću VEĆA PLATA za čak 1.400 evra," February 2, 2017, *Blic*, accessed on November 29, 2017 at <http://www.blic.rs/vesti/politika/srbijagas-u-sve-vecjoj-dubiozi-a-bajatovicu-veca-plata-za-cak-1400-evra/s2brymd>

²⁶ "Agencija: Bajatović će moći usmeno da se izjasni o predloženoj smeni," November 25, 2015, *Blic*, accessed on December 21, 2017 at <http://www.blic.rs/vesti/politika/agencija-bajatovic-ce-moci-usmeno-da-se-izjasni-o-predlozenoj-smeni/2fqzqbb>

²⁷ "Srbija u problemu – nema alternative za ruski gas," March 26, 2015, *Sputnik Srbija*, accessed on December 21, 2017 at <https://rs-lat.sputniknews.com/ekonomija/20150326893419/>

Russia's footprint in the gas sector extends through intermediary channels as well, such as Yugorosgaz, a joint venture between Srbijagas and Gazprom in which the Russian side controls 75 percent of the shares (see Fig. 7 below). The venture originally was set up to construct the gas interconnector with Bulgaria and to gasify southern Serbia, but in 2007, the company became the main intermediary in Srbijagas's gas trade with Russia. Yugorosgaz receives around a four percent premium on the gas it resells to Srbijagas, contributing to profits of approximately EUR 15 million in 2013 alone.²⁸

Gazprom has designed the gas supply structure to its benefit – and apparently at the expense of Srbijagas. Gazprom sells the contracted volume to Yugorosgaz in Ukraine, then Srbijagas buys the same gas, but at a four percent premium, and pays the additional shipping costs through Hungary. For years, the paradox has been such that after Yugorosgaz sells the Russian gas to Srbijagas, the national gas supplier resells it at a low, regulated price back to Yugorosgaz for its own distribution in southern Serbia, which contributes to persistent large losses on Srbijagas' financial statements.

Although many elements of the gas trade between Serbia and Russia remain unknown due to the confidentiality of the contracts, investigative reports from leading Serbian media outlets²⁹ show that Srbijagas bears significant losses due to its gas trade arrangements. Eventually, the Serbian taxpayer will have to foot the bill, most likely through the issue of more public debt to be covered by higher taxes or a cut in social expenditures. Yugorosgaz, on the other hand, does not reinvest its proceeds into developing its gas pipeline system in Serbia or constructing the interconnector with Bulgaria as negotiated by the Russian and Serbian governments, but instead divides the funds between the company's owners.³⁰ Srbijagas receives 25 percent of all proceeds, while the other 75 percent are transferred abroad, including 50 percent to Gazprom in Russia and 25 percent to another company, Centrex, which research shows is ultimately owned by Gazprom.

The failure of the Srbijagas management to restructure the company violated a key EBRD condition for the financing of the construction of the Bulgaria-Serbia gas interconnector, which could improve Serbia's energy security, as well as force down the price of gas imports. Gazprom has opposed the pipeline, as it would directly challenge the Russian major's dominant position in the Serbian market.

In Macedonia, where more than 80 percent of the country's energy comes from coal and oil, the role of the natural gas sector is marginal. However, the geopolitical considerations attached to a long-term contract

²⁸ Originally, the Bulgarian-Serbian interconnector was considered to be a pipeline to transport Russian gas in the future.

²⁹ E.g. Insider, TV B92.

³⁰ Apart from 100 km of pipeline built down to Nis before 2000, there has been very little progress in construction of the gas pipeline Nis-Dimitrovgrad (Bulgaria). In 2014, when Russia's Gazprom said it would abandon South Stream, Bulgaria and Serbia, which had signed a memorandum for the construction of the gas interconnector in 2012, were forced to look for alternative gas supply options.

with Gazprom, coupled with the Russia-led construction of domestic pipelines, have magnified the political importance of natural gas. Gas dependence on Russia is likely to increase based on planned investments in gasification infrastructure in the country. This raises the question of whether gasification is justified commercially, or is a response to political pressure to artificially grow the demand for gas.

Macedonians are heavily reliant on burning poor-quality woods and lignite, or brown coal, for heat. Because emissions from the fuels contribute to high levels of air pollution, household gasification is perceived as a means to reduce energy poverty. However, only the eastern city of Strumica – via the TransBalkan pipeline – currently has access to natural gas. (Another notable exception is the TE-TO gas-fired power plant in the capital, Skopje.) Overall, Macedonia typically consumes between 0.05 and 0.1 bcm of gas per year, the lowest rate of such consumption in Europe.³¹ (Gazprom delivered 0.07 bcm of gas to Macedonia in 2016.) The domestic gas network, which consists of more than 260 kilometers of pipelines, reaches the TE-TO plant and several industrial clients³² on the outskirts of Skopje.

Macedonia's low levels of gas consumption softened the impact of cuts to supply in 2006 and 2009, when disputes over debt between Gazprom and the government of Ukraine temporarily halted deliveries from Russia to southeastern Europe. Macedonia successfully switched to heavy fuels to make up for the drop-off in gas. Consecutive governments have continued to support natural gas network expansion in the country and engaged with the Gazprom-led South Stream and Turkish Stream pipelines. In July 2013, the Macedonian government signed a bilateral agreement with Russia to construct an offshoot of South Stream although there was great uncertainty regarding how exactly to link Macedonia to the pipeline.³³ After abandoning the project due to Brussels's pressure,³⁴ Russian President Vladimir Putin announced a new project, Turkish Stream, which would consist of two pipelines, each delivering a little less than 16 bcm of gas per year to Turkey. The first line would supply

³¹ Gazprom statistics on gas supply to Europe accessed at Gazprom's official website: <http://www.gazpromexport.ru/en/statistics/>

³² The high gas price and the inflexible take-or-pay terms in the contract with Gazprom have placed financial strain on some of the major gas consumers in the country. For example, TE-TO, co-owned by Russia's TKG-2 via its Macedonian subsidiary Balkan Energy Group, is controlled by Russian Senator and businessman Leonid Lebedev. The company accumulated around USD 120 million in gas debt to Gazprom (for the operation of two plants in Russia and one in Skopje), as reported in 2013. The exact amount of the gas debt in Macedonia alone is unknown due to the confidentiality of the agreement. TKG-2 owed Toplifikacija, the main heat distribution company, EUR 23 million at the end of 2015. Most of the debt was generated through a loan by Toplifikacija for the construction of CCHP in Skopje. In January 2017, the Russian bank VTB filed a claim in a Russian court to seize the heating plant in attempt to use the asset to recover some of TKG's debt to the bank. The difficult financial situation of the owners of the heating plant created a debt cascade affecting the heat distribution company, which could lead at best to the decapitalization of the company causing, problems with the reliability of supply, and at worst a full halt of the plant's operation, risking leaving 50,000 Skopje households without heat in the winter.

³³ B92 (2013). "Russia and Macedonia sign South Stream offshoot deal," July 24, 2013, accessed on November 16 at http://www.b92.net/eng/news/region.php?yyyy=2013&mm=07&dd=24&nav_id=87050

³⁴ RFERL (2014). "Bulgaria Suspends Work On South Stream Pipeline". Radio Free Europe, June 8, 2014, accessed on November 21, 2017 at <https://www.rferl.org/a/bulgaria-suspends-work-on-south-stream-pipeline/25414739.html>

only the Turkish domestic market, while the second would transport gas either through Greece or Bulgaria to Macedonia, Serbia, and Hungary along a new pipeline, TESLA, and would terminate at the Baumgarten gas hub near Vienna. These plans are similar to the initial South Stream project plans, but only TESLA has been included in the European Commission's Projects of Common Interest (PCI). PCI inclusion is a pre-condition for possible EU financing.³⁵ The pipeline is scheduled for 2019, which is highly unrealistic considering the slow progress of Turkish Stream and the general opposition of the EU to a new Russian pipeline from the south. The inclusion of TESLA in the list of EU Projects of Common Interest (PCI) in 2015 seems to be the result of heavy lobbying on the part of Hungary, which has been the diplomatic leader in pushing TESLA through.³⁶

The former Macedonian government embraced TESLA and worked closely with a Russian gas construction company, Stroytransgaz, to extend the domestic natural gas pipeline network. Stroytransgaz is owned by US and EU-sanctioned Gennady Timchenko. The same company was reportedly responsible for constructing an offshoot of South Stream before the project's cancellation.³⁷ The cancelled project was planned at USD 200-300 million and would have been partially financed by the Russian state as a way to repay USD 60 million in Soviet-era debt to Macedonia. Russia's Finance Ministry announced in February 2017 that it would clear the debt to Macedonia by the end of the year.³⁸ In effect, by repaying this longstanding gas debt to Macedonia by financing the expansion of domestic pipeline infrastructure, Russia would finance a company with strong ties to Kremlin that had previously received billions of dollars through other pipeline projects in Russia and Europe.

Despite the failure of South Stream and the somewhat unclear fate of TESLA, the government has partially followed through with plans for the expansion of its network. In August 2016, Stroytransgaz completed the construction of a 96 km, USD 75 million Klekovce-Negotino pipeline, linking Macedonia with the Serbian gas system.³⁹ The company also planned to complete a link to Greece, where it would allegedly connect to the second line of the Turkish Stream pipeline at the border. In October 2016, Macedonia's and Greece's transmission operators, MER and DESFA, signed an agreement to connect their networks via a 160 km interconnector between Stip, where the extension of the Russian-built Klekovce-Negotino pipeline ends. This new pipeline is a welcome move in the process of gas diversification that could possibly link the Macedonian gas system with Azeri gas flowing through the Trans-Adriatic

³⁵ Georgiev, Georgi (2015). "CE/SEE partners eye EU funds for Tesla gas pipeline project", SeeNews, August 28, 2015 accessed on November 21 at: <https://seenews.com/news/cesee-partners-eye-eu-funds-for-tesla-gas-pipeline-project-490558#sthash.zOUb2R0v.dpuf>

³⁶ Ibid.

³⁷ Luhn, Alec (2014). "Gennady Timchenko denies Putin links made him one of Russia's top oligarchs", 24.03.2014, accessed on November 16 at <https://www.theguardian.com/world/2014/mar/21/oligarch-timchenko-denies-putin-links-us-blacklist-sanctions>

³⁸ RT (2017). "Russia to clear entire Soviet debt by year-end", RT, 17.02.2017 accessed on November 10 at <https://www.rt.com/business/377676-russia-pays-soviet-debt/>

³⁹ "Macedonia completes part of its gas network", economynews.bg, 01.08.2016.

Pipeline (TAP).⁴⁰ Unfortunately, consecutive Macedonian governments have balked at this opportunity to diversify the gas supply. Instead, government officials have decided to pursue economically unrealistic, contractually rigid, Gazprom-managed pipeline projects: South Stream, Turkish Stream, and TESLA. The decision to begin large-scale gasification exclusively with a company close to the Kremlin (Stroytransgaz) and Gazprom in order to recoup its Soviet-era debt is a typical example of a region-wide pattern of Balkan governments ignoring their national interests for the sake of geopolitical delusions that have been nurtured by Russian and domestically-produced propaganda.

The key economic misconception associated with the South Stream project was that hosting a large Russian gas pipeline would transform local economies, create thousands of jobs, and generate new businesses. In this telling, the pipeline construction would benefit Balkan countries through cheaper natural gas, which would, in turn, facilitate expanded gas transmission. These opinions were not grounded in fact or detailed economic impact assessments, but were based on the statements of high-level politicians and certain business leaders.⁴¹ The other myth – that the Russian pipeline project would bring more energy security to the host countries – was thoroughly debunked by the experience of Ukraine and Belarus, which have both faced continued supply disruptions despite serving as the main transit countries for Russian gas.

Bosnia and Herzegovina has fallen into the same trap. The country is fully dependent on Russian imports. Natural gas covers around 25 percent of the needs of the central heating utilities (the rest comes from fuel oil), but is otherwise insignificant for the country's energy sector. Bosnia and Herzegovina paid the second-highest gas import price in 2013 at USD 515/1,000 cubic meters, trailing only Macedonia at USD 564.⁴² In southeastern Europe, Bosnia and Herzegovina was one of the hardest hit by the 2009 drop-off in Russian gas transit through Ukraine during a price dispute between Gazprom and Naftogaz that saw gas supplies halved.⁴³ In 2015, natural gas made up only around four percent of the total final energy consumption, and in absolute numbers, has not gone beyond 220 million cubic meters per annum. Despite the limited use of natural gas in Bosnia and Herzegovina, Russia has sought to take advantage of the country's import dependence to exacerbate divisions between the country's entities.

The relationship with Gazprom remains largely asymmetrical, in which the Russian supplier often uses its monopoly position to play FBiH and

⁴⁰ Balkan Energy (2016). "MER and DESFA signed MoU on gas pipeline construction," October 14, 2016 accessed on 10 November at <http://balkanenergy.com/mer-and-desfa-signed-mou-on-gas-pipeline-construction-region-14-october-2016/>

⁴¹ Marusic, Sinisa (2013). "South Stream Deal Boosts Macedonia's Gas Prospects", BalkanInsight, July 26, 2013.

⁴² Gazprom's Grip: Russia's Leverage Over Europe. RadioFreeEurope – Infographics on the Russian gas dependence in Europe by country, accessed on November 9, 2017 at <https://www.rferl.org/a/gazprom-russia-gas-leverage-europe/25441983.html>

⁴³ Ralchev, Stefan. (2009). "Russian Gas Supplies to Bosnia Cut by Half," See News, January 6, 2009, accessed on November 13, 2017 at <https://seenews.com/news/update-2-russian-gas-supplies-to-bosnia-cut-by-half-239252>

RS against each other. For example, in February 2015, the head of RS's GAS RES gas supplier and the CEO of Gazprom signed a new agreement for direct gas supply to the entity, bypassing one of FBiH's gas suppliers – namely BH Gas – at preferential pricing terms, after talks between the CEO of Gazprom and President Dodik in September 2014.⁴⁴ The contract stipulated that Gazprom would deliver 106 million cubic meters of gas to RS from July 1, 2015, to December 31, 2016.⁴⁵ The agreement was tied to a newly-created joint company (60 percent for Gazprom and 40 percent for RS), as compared to 51 percent to 49 percent in Serbia and 50 percent and 50 percent in Bulgaria, to construct an offshoot of South Stream from RS to FBiH. The state government was not consulted on this issue at all, though. Although energy sector governance is within the competencies of each entity, RS, with a geographic advantage thanks to its proximity to Serbia's infrastructure, has significant power over the gas supply to FBiH.

Both FBiH and RS expected that South Stream would resolve their problems with gas shortages due to bottlenecks on the existing pipeline network caused by disputes between the two entities. The goal of the leadership of RS was to construct 280 km of gas pipelines to the capital of the entity, Banja Luka, and 46 residential areas in RS. This plan is in an RS gasification plan dating to 2002, when the company Slavija International, from Laktasi, Dodik's birthplace and a stronghold of his Alliance of Independent Social Democrats (SNSD), was awarded a concession contract for construction of a 480 km-long gas pipeline along the Sava river. South Stream would follow exactly the same route with a capacity of between 1.5 bcm/yr to 1.7 bcm/yr. In concluding the South Stream agreement, RS however circumvented FBiH and the state government, effectively blocking any access to the planned pipeline beyond the gas distribution network operated by RS. According to RS estimates, direct and indirect losses for Bosnia and Herzegovina from the cancellation of South Stream exceeded EUR two billion.⁴⁶

On the part of FBiH, Gazprom concluded supply contracts with BH Gas and Energoinvest on an annual basis, with the latest valid until the end of 2017. BH Gas is the single wholesale supplier and one of two gas system operators in the entity (the other one is Gas Promet). In RS, there is another gas transmission operator, Sarajevogas Istocno Sarajevo. Between FBiH and RS, there is only one connection with the domestic transmission system at Zvornik, located in RS. Constant ethnic political infighting and the fact that there are three different transmission operators have contributed to the system's underperformance and supply shortages.⁴⁷ The fact that there are two different gas sector laws and reg-

⁴⁴ Posaner Josh (2014). "Gazprom's gas deal in Republika Srpska provides South Stream stop-gap," LSEE Southeast Europe Research Blog, September 16, 2014, accessed on November 13, 2017 at <http://blogs.lse.ac.uk/lsee/2014/09/16/gazproms-gas-deal-in-republika-srpska-provides-south-stream-stop-gap/>

⁴⁵ Gazprom Export Press Release, February 27, 2015 accessed on November 13, 2017 at <http://www.gazpromexport.ru/en/presscenter/press/1531/>

⁴⁶ Article of Deutsche Welle of December 4, 2014: <http://www.dw.com/hr/i-bih-ostala-bez-milijunskih-investicija/a-18109661>

⁴⁷ European Energy Community (2017). Annual Implementation Report. September 1, 2017, Energy Community Secretariat.

ulations for transmission system operators (TSOs) means that gas suppliers face significant difficulties in shipping gas from one entity to the other, as capacity booking rules differ and limited cooperation between operators means that physical gas bottlenecks often halt the gas supply.

Since the natural gas sector is regulated at the entity level and there are three separate TSOs (BH Gas in the FBiH and Gas Promet and Sarajevogas Istocno Sarajevo in RS), the transmission system is used very inefficiently.⁴⁸ In addition, the network's extensions since 2013, such as the construction of the Zenica-Travnik in FBiH and the Sepak-Bjeljina pipelines in RS, which aimed to alleviate bottlenecks and expand access for final consumers to the gas supply, are not in operation. A lawsuit filed by the lead contractor, which had complained about the arbitrary termination of its construction contract by BH Gas, blocked the former.⁴⁹ The latter is not functioning due to a dispute about who should operate the pipeline between the TSO, Sarajevogas Istocno Sarajevo, which is also the distribution system operator (DSO), and the retail supplier GAS RES, owned by the government of RS-government-owned.

The main reason for the inefficiencies of the gas sector, which Russia exploited to prevent energy system integration between FBiH and RS, is non-compliance with the EU Third Energy Package. Neither FBiH nor RS have unbundled the transmission and supply activities of their respective gas companies, BH Gas and Sarajevogas Istocno Sarajevo. The government of RS has explicitly provided an exemption from the unbundling rules for distribution companies with fewer than 100,000 customers (an almost impossible target), which are the same companies involved in the supply and trading of gas. Persistent violations of the EU natural gas acquis by Bosnia and Herzegovina have pushed the Energy Community to impose so-far unspecified measures against both entities' governments. These could include, among others, the withdrawal of EU funding for energy infrastructure projects, and even Bosnia's expulsion from the Energy Community Treaty. The latter would significantly delay accession talks with the EU, in which energy is one of the key negotiation chapters.

Russia has pursued different strategies vis-à-vis FBiH and RS, which can be explained by its geopolitical priorities. Another example of RS's preferential treatment by Gazprom is an agreement signed with Russia in 2017. According to this agreement, GAS RES is not obliged to participate in a repayment of the USD 98 million gas debt accumulated by Bosnia and Herzegovina for gas supplies from Russia during the 1992 – 1995 war, and only BH Gas from FBiH should be responsible.⁵⁰ In May 2017, Russia sought through official means full repayment of the debt, following a March 2017 deal between Bosnia and Herzegovina and Russia on the set-

⁴⁸ European Energy Community (2017). Annual Implementation Report. September 1, 2017, Energy Community Secretariat.

⁴⁹ Center for Investigative Reporting (CIN). (2016). Expensive and Useless Pipeline. September 22, 2016, accessed on December 18, 2017 at <https://www.cin.ba/en/skupi-beskorisni-gasovod/>

⁵⁰ Garaca, Maja (2017). "Russia seeks repayment of \$98 mln gas debt from Bosnia," May 16, 2017, accessed on November 13, 2017 at <https://seenews.com/news/russia-seeks-repayment-of-98-mln-gas-debt-from-bosnia-report-568868#sthash.WBIIPSFd.dpuf>

tlement of the USD 125.2 million outstanding debt of the USSR to Socialist Yugoslavia.⁵¹ FBiH was to receive 58 percent, or USD 72.6 million, from the debt; RS – 29 percent or USD 36.3 million; Bosnian state institutions – USD 10 percent or 12.5 million; and the Brcko district – three percent or USD 3.8 million.⁵²

Bosnia and Herzegovina was the last of the states of the former Yugoslavia to resolve its debt dispute with Russia, doing so only in 2017. Additionally, Bosnia and Herzegovina was the only Balkan country to receive its post-Yugoslav share of the clearance of the Russian debt in cash. The BH Gas company complained that the settlement of the gas debt issue was purposefully mismanaged to the benefit of RS.⁵³

As a consequence of the redistribution of the debt burden entirely to FBiH, the financial situation of BH Gas has become precarious, which may potentially endanger Sarajevo's supply in the winter of 2017-18. After receiving the cash reimbursement from Moscow, it still owes Gazprom USD 25.4 million. FBiH has also expressed concerns that RS could use its geographic position as a transit region for the gas pipeline via Zvornik, in RS, and cut the gas supply to FBiH under pressure from Gazprom. RS has already cooperated with the Russian supplier to circumvent FBiH in the South Stream negotiations and disrupt the construction of new pipelines to alternative sources of gas. Full control of the natural gas supply to the whole territory of Bosnia and Herzegovina by RS would create a risk for gas consumers in FBiH, which accounts for half of the total gas demand in the country.

Faced with the abandonment of South Stream and a lack of progress on the TESLA pipeline, Russia has adopted a new strategy of shipping more gas to RS. In mid-December 2017, GAS RES and Gazprom SPG, a subsidiary of the Russian state-owned gas giant, agreed to form a joint venture to build a liquefied natural gas (LNG) plant in the town of Zvornik on the border with Serbia, where the Russian gas enters RS.⁵⁴ The new project could be interpreted as an attempt to replace South Stream.

Furthermore, RS has worked to prevent the opening of a new gas supply route to FBiH from Croatia, so that RS can maintain its monopoly over supply to FBiH. To achieve this, RS has limited the scope and size of a low-pressure gas pipeline that is planned to be built exclusively for the needs of the Oil Refinery in Brod (a company privatized with Russian capital in a deal brokered by RS authorities). For full-scale gas diversification in FBiH to succeed, there is a need for a high-pressure gas pipeline such as the previously proposed Brod-Zenica interconnector from Croatia (the North-South pipeline). This gas pipeline built by BH-Gas and financed by EBRD would have provided not only FBiH, but the whole country with access to an alternative source of supply. The

⁵¹ Garaca, Maja (2017). "Bosnia's BH Gas confirms Russia seeks repayment of gas debt," May 18, 2017, accessed on November 13, 2017 at <https://seenews.com/news/bosnias-bh-gas-confirms-russia-seeks-repayment-of-gas-debt-569151>

⁵² Ibid.

⁵³ Ibid.

⁵⁴ Reuters. (2017). "Bosnian, Russian gas firms to form a joint venture." December 16, 2017.

North-South pipeline would also diminish the use of fuel oil for heat generation in district heating plants across the country, a major source of pollution.

RS has always objected to a North-South pipeline project,⁵⁵ instead proposing the Sava pipeline (also known as the East-West pipeline), which would also reach the Croatian border shipping Russian gas. Sava was conceived by Gazprom and the Serbian gas supplier, Srbijagas, in 2002, but did not advance. The project appears to be dead, especially after the cancellation of South Stream, which would have supplied Sava with Russian gas. For now, only the North-South pipeline can potentially be revived if RS does not continue to sabotage the project.

Croatia and FBiH took steps to revive the North-South pipeline in 2017. In April, Plinacro (a Croatian Gas Company) and BH Gas agreed to cooperate in connecting a gas transmission network through Croatia and Bosnia and Herzegovina through a EUR 80 million, 160-km pipeline, so that FBiH could be connected to a planned Krk LNG terminal on the Adriatic coast.⁵⁶ The gas pipeline would, according to this agreement, connect Zagvozd, Imotski, Posusje, and Travnik/Novi Travnik. Adding this alternative would help Bosnia and Herzegovina fulfil the requirements of the Energy Community, according to which the country must have more than three sources of gas supply.⁵⁷ The planned new pipeline network connecting Bosnia and Herzegovina and Croatia represent a part of the Energy Community initiative to complete a Gas Ring within the Western Balkans, which would connect to the IAP pipeline along the Adriatic coast and eventually to TAP in Albania. Although RS would also benefit from receiving diversified gas supplies, the entity decided to focus on Russia-led gas pipelines originating in Serbia instead.

Another associated problem with small pipeline projects such as Sava and North-South in the Balkans is the lack of investment interest in a small gas market with poor prospects for significant expansion. In general, the lack of gas demand makes it difficult to justify the high investment costs. It has been difficult for Bosnia and Herzegovina to reconcile the importance of diversification for the security of supply with its limited economic viability. Demand has been low because gasification rates are among the lowest in the region, and household gasification has not been attractive due to high prices caused by inefficiency and regulatory fragmentation.

Russian presence in the oil sector is greater and much more direct. Between 2003 and 2008, Russian state-owned and private companies gained significant – or as in the case of Serbia and Bosnia and Herzegovina, dominant – control over the oil markets. In Serbia, Gazprom purchased

⁵⁵ Pavlic, Vedran (2017). "Bosnian Serbs Reject Croatian Gas," March 5, 2017, accessed on November 13, 2017 at <https://www.total-croatia-news.com/business/17230-bosnian-serbs-reject-croatian-gas>

⁵⁶ "Bosnia, Croatia: New cross border gas pipeline," SEE Energy News, May 18, 2017, accessed on November 14, 2017 at <https://serbia-energy.eu/bosnia-croatia-new-cross-border-gas-pipeline/>

⁵⁷ The Energy Community ensures the implementation of the EU energy acquis in the member-countries. The Regulation Concerning Measures to Safeguard Security of Gas Supply (994/2010/EU) stipulating the three-sources rule is part of the acquis.

the national oil company, NIS, in 2008, while the private Russian company Lukoil bought out the second biggest fuels retailer, Beopetrol, in 2003. These two Russian companies dominate the upstream, refining, wholesale and retail sectors.⁵⁸ According to 2015 data, NIS owns 325 gas stations (24 percent of all gas stations in Serbia), while Lukoil has 148 (10 percent), making them the two biggest retailers in Serbia. In addition, NIS supplies 78 percent of the fuels sold by other competitive retail gas stations. This data suggests that Russian-owned firms have almost full control and monopoly over the fuels market, with more than a third of the retail market, all upstream production, and most wholesale storage facilities. In addition, of 1,576 thousand tons of petroleum products sold on Serbia's retail market in 2014, 642 (41 percent) were sold at NIS gas stations. This data suggests Russia has almost complete control of the oil market and thereby reaps enormous profits from its monopoly. While crude oil prices fell by more than half in 2014, retail gasoline and diesel prices fell between 4.4 percent and 10.4 percent, far below the decline registered in European oil trading indices such as the Platt's Mediterranean Quote.⁵⁹

In Bosnia and Herzegovina, the Russian state-owned oil company Zarubezhneft won privatization tenders for two refineries, Rafinerija Nafta Brod and the Modrica motor oil processing facility, for a combined EUR 125.8 million in 2007, far below the initial asking price of EUR 285 million in 2005. Russian officials described the project as both politically and economically part of a broader strategy to strengthen alliances with countries of the Western Balkans (Zarubezhneft took a loan from the Russian state-owned Development Bank to buy the two refineries).⁶⁰ The refineries became the core of the Russian-owned Optima Group, which by 2011 contributed 19 percent of Bosnia and Herzegovina's GDP, according to the company's annual report.⁶¹ Zarubezhneft also acquired an 80 percent share in the Nestro Petrol wholesale and retail fuels supplier, now the country's largest gas station chain. Thus, Optima Group controls roughly

⁵⁸ The company has aggressively expanded throughout the region, entering the wholesale and retail fuel markets of Serbia, Romania, Bulgaria and Bosnia and Herzegovina, and now operates 400 fuel stations in the region. NIS operates 37 gas stations in Bosnia and Herzegovina, making it among the top four retailers (11 percent of the total fuels market) in the country.

⁵⁹ *Извештај о секторској анализи тржишта трговине на велико и трговине на мало дериватима нафте у 2015. години*, Commission for the Protection of Competition of the Republic of Serbia, December 2016, p. 35, <http://www.kzk.gov.rs/kzk/wp-content/uploads/2017/01/Izvestaj-o-sektorskoj-analizi-trzista-trgovine-na-veliko-i-trgovine-na-malo-derivatima-nafte-u-2015-godini.pdf>

⁶⁰ Sito-Sucic. (2009). "Bosnian refinery reopening shows Russia's hand," *New York Times*, January 6, 2009, accessed on November 15, 2017 at <http://www.nytimes.com/2009/01/06/business/worldbusiness/06iht-bosoil.4.19127279.html>. In 2011, RS granted a Zarubezhneft-NIS joint venture, Jadran-Naftagas, a 28-year exclusive concession for the exploration and production of oil and gas on its territory (but not on the territory of FBiH). Jadran Naftagas would invest USD 41 million in exploration for the first three years, and USD 188 million for the next 25 years. So far, oil reserves have been discovered in several places in northeastern Bosnia and Herzegovina, which could further increase Russia's presence in the oil sector, if and when production starts. However, despite the initial excitement, there has been little activity on the blocks so far. In 2011, RS granted a Zarubezhneft-NIS joint venture, Jadran-Naftagas, a 28-year exclusive concession for the exploration and production of oil and gas on its territory (but not on the territory of FBiH). Jadran Naftagas would invest USD 41 million in exploration for the first three years, and USD 188 million for the next 25 years.

⁶¹ Zarubezhneft 2011 Annual Report. This figure significantly exceeds the Russian corporate footprint as analyzed by turnover, which estimates the share that the turnover of Russian companies plays in the economy's total turnover.

35 percent of Bosnia and Herzegovina's wholesale fuels market. This percentage represents a decrease from 60 percent in 2011, the result of increasing competition from the Croatian company INA, and the entry of smaller traders such as Gazprom-owned NIS, with a seven percent market share.⁶² However, Zarubezhneft's ownership of both refineries and the bulk of the oil infrastructure in the country enables it to moderate supply and undermine its competition.

In Macedonia and Montenegro, Lukoil has expanded its market presence to become the second largest retail supplier of fuels. Makpetrol is the biggest distributor of oil products, with around half of all gas stations in Macedonia, while in Montenegro, the market leader is Jugopetrol, owned by the partially state-owned Greek company Hellenic Petroleum.

Lukoil currently controls around ten percent of final fuel sales in each country and is not able to influence price-setting with the same success as in neighboring Bulgaria, where Lukoil owns the largest refinery in south-eastern Europe and exports more than half its production to Macedonia, Greece, Turkey, Serbia and Montenegro. Before 2012, Macedonia imported most of its crude oil from Russia (though imports fell from USD 497 million in 2012 to nearly nothing in 2014).⁶³ Currently, Macedonia is fully dependent on the import of crude oil from the port of Thessaloniki in Greece via a pipeline to the OKTA refinery near Skopje, purchased by Hellenic Petroleum in 1999. In order to cover some of its debt obligations to its international creditors, the Greek government previously offered to sell its state share in Hellenic Petroleum. Both Lukoil and Gazprom expressed interest in the purchase. If the Greek company had come under Russian control, this would have significantly increased Russia's corporate presence in the Macedonian and Montenegrin oil sectors.

Allegations of corruption have marred the expansion of Russia's corporate footprint in the region's oil sector. These allegations arise at all stages: during the privatization of oil assets, implementation of privatization agreements, and the abuse of dominant market positions for non-competitive pricing and tax evasion. Gazprom's below-market-price purchase of the controlling stake in NIS has raised serious questions and has led to some allegations of corruption.⁶⁴ The total value of NIS, according to the preliminary estimates of privatization advisors in 2006, was between EUR 1.2 and 1.6 billion. In other words, 51 percent of NIS was worth EUR 612-816 million (excluding the value of domestic oil reserves). Interestingly, the agreement and its associated protocol set the purchasing price for

⁶² Zarubezhneft 2016 Annual Report. In 2011, the company controlled close to half of the whole market.

⁶³ Observatory of Economic Complexity. What does Macedonia import from Russia?, accessed on November 16 at <http://atlas.media.mit.edu/en/visualize/line/hs92/import/mkd/rus/show/1995.2015/>

⁶⁴ Even before his election, Alexander Vucic criticized the corrupt nature of the agreement with Gazprom and the acquisition of NIS, saying that a higher share of its profit should be transferred to the state budget, and the proceeds should be used to repay Srbijagas's debt to Gazprom. When Vucic became Serbia's Prime Minister, Serbia's prosecutor opened an investigation into the 2008 deal. Media reported that the investigation was to pressure the Russian side to take over the petrochemical company Petrohemija, which in 2014 owed around EUR 20 million to NIS for the fuel it was using for its production. The investigation was completed in 2016, but no indictment was issued.

the controlling stake in NIS at EUR 400 million, with the obligation that Gazprom would finance a modernization program worth EUR 500 million. Gazprom then borrowed funds to fulfill its obligation instead of using its own equity. By using debt instead of equity, Gazprom committed NIS to repay the loan with interest. In addition, the Agreement granted Gazprom favorable terms for the extraction of oil and gas in Serbia. It set NIS's mining tax at three percent (lower than the seven percent tax for other companies, and far below international practice of between 15 and 30 percent), and exempted NIS from future tax increases until the company becomes viable. Considering Gazprom's massive modernization project and ongoing oil and gas exploration, such terms may mean that the Serbian state has decided to forego a great amount of potential future revenue. Most Serbian energy officials claim that the mining tax for NIS should remain the same until the agreement's expiration in 2038. In 2009, the Serbian Constitutional Court upheld the constitutionality of the bilateral agreement.⁶⁵ The Russian company's favorable mining tax treatment and its excessively privileged position on the market are among the most contentious points of the deal.⁶⁶

The privatization of Beopetrol by Lukoil in 2003 also raised concerns about Russian involvement. According to the privatization agreement, Lukoil pledged to invest USD 106.8 million in the company's infrastructure. In a September 2013 report on Beopetrol's privatization, the Serbian Anti-Corruption Council said that Lukoil never honored the agreement, causing damage to the company equivalent to millions of US dollars. According to the Council's report, instead of investing in Beopetrol's infrastructure, Lukoil violated the privatization arrangement by actually dipping into Beopetrol's funds to lend the parent company USD 120 million, or around 90 percent of what it had just paid to purchase this state-owned company. The Council claimed that Serbia's Agency for Privatization never really controlled the process and never prevented Lukoil from proceeding with the loan transfers.⁶⁷ Moreover, Lukoil's then-head in Serbia, Srdjan Dabic, who was involved in the privatization, has been linked to a Belgrade mayor, Sinisa Mali (a close associate of Serbia's then-Prime Minister, Aleksander Vucic), who bought 14 apartments on the Black Sea

⁶⁵ International and Security Affairs Centre – ISAC Fund and Law Office 'Nikolić, Kokanović, Otašević', (2009), "Pravna analiza aranžmana između Srbije i Susije u oblasti naftne i gasne privrede," December 21, 2009, p. 6, accessed on December 21, 2017 at <https://www.isac-fund.org/download/Pravna%20Analiza%20Aranžmana%20Rusije%20i%20Srbije%20u%20obalasti%20Naftne%20i%20Gasne%20Privrede-FINAL.pdf>

⁶⁶ The mining royalty for NIS (Gazprom) is seven percent of the revenue, while the company pays just three percent. In many other oil and gas producing countries, the royalty is between 20 and 30 percent.

SerbiaEnergy. (2017). "Serbia mining: According to experts, little chance to increase the mining royalty in Serbia." February 23, 2017.

⁶⁷ Dojčinović, Stevan, Peco Dragana and Tchobanov, Atanas. (2015). "The Mayor's Hidden Property". Organized Crime and Corruption Reporting Project. October 19, 2015, accessed on November 30, 2017 at <https://www.occrp.org/mayorsstory/The-Mayors-Hidden-Property/index.html>

The Privatisation of Beopetrol a.d., Anticorruption Council, Government of Serbia, Issue 72, September 30, 2013. The short report is available in Serbian at the Councils web-site: <http://www.antikorupcija-savet.gov.rs/sr-Cyrl-CS/izvestaji/cid1028-2379/izvestaj-o-privatizaciji-beopetrola-ad>. As of 2016, the Council still upholds its claims despite vehement objections from Lukoil. See, for example, this short report from the *Danas* newspaper in Serbian: <http://www.antikorupcija-savet.gov.rs/sr-Cyrl-CS/radio-televizija-i-stampa/cid1037-3112/beopetrol-je-bukvalno-kupio-samog-sebe>

coast from Dabic for USD 6.1 million in 2012.⁶⁸ Mali denied that he bought the apartments.⁶⁹

Non-transparent and non-competitive privatization processes have been used systematically to acquire strategic assets in the region. In a similar fashion, Russia has acquired oil, gas, minerals, and manufacturing assets in Serbia, Bulgaria, Macedonia, and Montenegro. These agreements often undervalue the assets, and the new owners often fail to implement agreed-upon investment plans, while managing the companies into losses and decapitalization. There is often also a substantial indirect effect on the states themselves, as these large loss-making companies typically do not pay corporate taxes and fail to create new jobs, which can generate fiscal and socio-economic vulnerabilities.

Similarly, the refinery privatization in Bosnia and Herzegovina occurred without tenders and without any public debate.⁷⁰ It was completed quickly, possibly to rescue three bankrupt state-owned companies with debts of over EUR 72 million. Zarubezhneft pledged to pay off the arrears and invest an additional EUR 600 to 700 million in modernizing the facilities.⁷¹ An independent audit by Deloitte in 2015 showed that Optima Group was facing a severe debt crisis, with short-term debts exceeding assets by EUR 20 million (the company's total debt was over EUR 320 million in 2016), and that a number of suspicious transactions had been conducted by the holding's management.⁷² Opposition leaders and some experts alleged that these transactions were by potential sources for money laundering operations by the leadership of RS, as well as to channel Russian political support.⁷³ Another theory is that Russia threatened to cut the crude oil supply to the Brod refinery unless it came under the ownership of a Russian company.⁷⁴

RS did not enforce the refineries sale's conditions, which included investments in the modernization of the facilities. By 2016, Optima Group had invested barely EUR 120 million in modernizing the production facilities and raising the output capacity of the refineries (representing six times less than the initial pledge of at least EUR 675 million).⁷⁵ Since then, there have been a number of high-level meetings involving the management of Zarubezhneft and President Dodik, during which it was reported that the Russians promised millions in further investment.

⁶⁸ Ibid.

⁶⁹ "Mali: Nemam milione ni 24 stana, podneo sam prijave", 24 December 2015, *N1*, accessed on December 21, 2017 at <http://rs.n1info.com/a120718/Vesti/Mali-Nemam-milione-ni-24-stana.html>

⁷⁰ "Russia-owned Bosnian Oil Refinery Reopens," *BalkanInsight*, November 27, 2008, accessed on November 15, 2017 at <http://www.balkaninsight.com/en/article/russia-owned-bosnian-oil-refinery-reopens>

⁷¹ Ibid.

⁷² Panic, Katarina (2015). "Ailing Bosnian Oil Firm Flogs Assets to Raise Cash," *BalkanInsight*, June 26, 2015.

⁷³ Ibid.

⁷⁴ RWR Advisory Group (2016). *Economic and Financial (E&F) Threat Assessment for Bosnia and Herzegovina: Assessing the Activities of Russian State-Owned Enterprises in Bosnia and Herzegovina*. RWR, March 4, 2016.

⁷⁵ Optima Group website page accessed on November 15 at <http://optimagrupa.net/en/otzima/>

Most recently, in June 2017, Zarubezhneft announced its construction plans for a low-pressure gas pipeline from the Brod refinery to Croatia that would alleviate the high levels of air pollution in both Croatia and RS's Brod valley.⁷⁶ The announcement came less than a month after a meeting of the foreign ministers of Russia and Croatia on the pollution issue in Slavonski Brod. BH Gas objected to this construction project, claiming that it would block an alternative gas interconnector from Bosnia to Croatia supplying both entities, as well as the Brod refinery.⁷⁷

The accumulation of a debt of around EUR 300 million by the Brod refinery has also affected its production levels and has prompted its management to begin selling some non-essential assets. According to a leader of the People's Democratic Movement (NDP), this is not consistent with the privatization contract.⁷⁸ The auditing company KPMG stated in a 2016 report that Optima Group would not survive without a bailout from the parent company.⁷⁹ However, continued negative financial results have not prompted the sale of the whole business, and some experts claim that Optima Group has preserved its position in the country for political reasons.⁸⁰

Leveraging Russian Presence in the Financial Sector

Banking

Although Russia's presence in the finance, banking and insurance sectors is limited, the recent default of Croatian retail giant Agrokor on a loan from Russian state-owned Sberbank could provide Moscow with an excellent opportunity to expand its political influence in the region. If Agrokor's subsidiaries in Serbia fail, it could trigger a domino effect of bankruptcies of the hundreds of businesses dependent on supplying on Agrokor, which in turn could lead to mass layoffs and, consequently, social unrest and political instability.

Before describing the fallout of Agrokor's debt crisis, this report explores the structure of Russia's presence in the financial sectors of Western Balkan countries. Over the past decade, two major Russian state-owned banks have been active in the region: Moskowska Banka, now part of the VTB group, which opened its first branch in 2008 as a greenfield investment, and the Russian state-owned Sberbank, which entered the market in 2012 by purchasing the banking arm of Volksbank International in Central and

⁷⁶ See Energy News (2017). "Zarubezhneft interested in the construction of low-pressure BiH-Croatia gas connection," See Energy News, June 14, 2017.

⁷⁷ Ibid.

⁷⁸ Ibid.

⁷⁹ Garac, Maja (2017). "Future of Bosnian oil refinery Brod uncertain without aid from Russian parent", SeeNews, April 11, 2017, accessed on November 15 at <https://seenews.com/news/future-of-bosnian-oil-refinery-brod-uncertain-without-aid-from-russian-parent-kpmg-564876#sthash.x7isjvaW.dpuf>

⁸⁰ Djurdjevic, Maja (2016). "Russia's Political Interests Drive Investments in Bosnia," July 4, 2016 accessed on November 15, 2017 at <http://www.balkaninsight.com/en/article/russia-s-political-interests-drive-investments-in-bosnia-06-30-2016>

Eastern Europe. Another small domestic institution, the Marfin bank, was recently taken over by the Czech Expobank, owned by a Russian businessman, Igor Vladimirovich Kim; there is some anecdotal evidence of Kim's links with President Putin.⁸¹ Of the four countries assessed, these banks operate only in Serbia and Bosnia and Herzegovina.

Upon entering Serbia, Sberbank expressed its readiness to invest EUR 100 million in Serbian export companies tied to the Russian market, as well as to help attract a strategic partner to purchase the Smederevo Steel Plant.⁸² To date, Sberbank has not significantly increased its market share in Serbia, and maintains the relatively low profitability of its previous owner. In addition, the bank's initial plans to finance the acquisition of the Smederevo steel plant did not go beyond a formal agreement, and cooperation with companies exporting to Russia did not materialize in large numbers.⁸³ Sberbank has preserved the investment policy of its Austrian predecessor and has not gotten involved in developing business cooperation with the largest privately-owned companies in Serbia, since local businessmen own many of these companies.⁸⁴ Sberbank considers these businesses risky, as several banks in Serbia collapsed in 2008-2015, supposedly due to political meddling into their business. Sberbank, however, was interested in purchasing the Komercijalna Banka or Banka Intesa (a Serbian subsidiary of Italy's Banca Intesa) in late 2013, as the latter has been the biggest creditor of Srbijagas.⁸⁵ No agreement was reached though, and there have been no new developments in the past four years.

Sberbank has 51 offices in Bosnia and Herzegovina. According to an assessment of the banking sector by the IMF published in 2015,⁸⁶ Sberbank is the sixth-largest financial institution in the country by assets. It has around 100,000 clients and EUR 593 million in assets (five percent of total bank assets). In other words, this is almost twice its assets as compared with 2012, when Sberbank entered the market.⁸⁷ Its loans and deposit portfolios have also been steadily rising, to around EUR 473 million and EUR 390 million in 2016. Sberbank's interests are primarily in corporate finance and energy projects.

Sberbank is more active in RS, where it is the fourth-largest bank. It also services Optima Group and an energy company, EFT. EFT is owned by offshore companies in the UK that are reportedly under the ultimate control of a Serbian businessman, Vuk Hamovic. The UK Serious Fraud Office previously investigated Hamovic for international corruption related to the alleged rigging of electricity-trading deals

⁸¹ Bjelotomic, Snezana. "Marfin Bank: Putin's man Igor Kim gets green light for takeover." Serbianmonitor.com. November 30, 2016.

⁸² "Sberbanka traži partnera za Železaru Smederevo," RT Vojvodina website, August 23, 2012, http://rtv.rs/sr_ci/ekonomija/sberbanka-trazi-partnera-za-zelezaru-smederevo_338100.html

⁸³ Interview with the source close to Sberbank Serbia August 7, 2017.

⁸⁴ Ibid.

⁸⁵ "Rusi žele Komercijalnu banku?" B92, November 25, 2013, http://www.b92.net/biz/vesti/srbija.php?yyyy=2013&mm=11&dd=25&nav_id=781821

⁸⁶ Report available on: <https://www.imf.org/external/pubs/ft/scr/2015/cr15213.pdf>

⁸⁷ Sberbank Bosnia & Herzegovina 2016 Annual Report, accessed at https://www.sberbank.ba/upload/docs/sb_en_online_ZOG.pdf

and manipulation of foreign aid payments, though the case was dropped.⁸⁸ In 2014, Sberbank financed EFT's 21.2 million purchase of coal processing and transportation equipment for a Stanari coalmine. The mine was intended to supply coal to EFT's 300-MW Stanari thermal power plant, constructed with a 350 million EUR loan provided by the China Development Bank.⁸⁹

As a whole, Sberbank's activity in the Western Balkans has been relatively passive. Yet one important exception is the bank's assertive investment in the region's largest retailer, Croatian holding Agrokor. The company, the owner of which, Ivica Todoric, has been reported to have close ties to Croatia's government over the years, has functioned as a highly centralized and in many respects unreformed business. Relying heavily on bank loans, the company has expanded into almost all countries of the Western Balkan. In early 2017, Agrokor employed some 60,000 people throughout the region and had an income equal to roughly 15 percent of Croatian GDP. The company simultaneously accumulated large debts, totaling around USD 6.4 billion or six times its equity.⁹⁰ It owes around 18 percent of its debt to Sberbank, while VTB has provided around EUR 300 million in loans (5.4 percent of the total) (See Fig. 8). Sberbank also supported Agrokor's acquisition of a Slovenian retailer, Merkator, in 2014, which in turn owned the Serbian chain Roda. At the time of the Merkator buy-out by Agrokor, Western creditors were skeptical of the company's ability to finance the purchase. Sberbank was the only institution that backed the Croatian holding, providing it with a EUR 600 million loan, followed by a second EUR 400 million loan to improve the company's financial health. Agrokor used the shares of some of its major subsidiaries to secure the second loan, including the Croatia-based PIK Vinkovci, Ledo, Zvijezda, and Jamnica.

Despite ballooning debt and unsustainable growth, Agrokor remained relatively stable until February 2017, when Russian Ambassador to Croatia Anvar Azimov threatened that Agrokor "will have to repay the loans from Russia and Russian banks or will face the consequences."⁹¹ He added that the company had financial problems and that this time, Russian banks would not come to its rescue. The statement sent shockwaves through the market. In the following days, credit agencies downgraded Agrokor's long-term debt rating, which led to a stampede of creditors asking for the repayment of their loans. Sberbank later clarified that the bank was not interested in acquiring Agrokor's businesses, but only in improving the holding's management.⁹²

⁸⁸ Leigh, David and Evans, Rob. "Fraud office drops Bosnia corruption case". The Guardian, June 3, 2008.

⁸⁹ EFT (2014). "Loan Agreement for the Stanari Mine Signed Today", PR statement from the EFT website published on April 16, 2014, accessed on December 1, 2017 at <http://www.eft-group.net/index.php/news/single/68/Loan-Agreement-for-the-Stanari-Mine-Signed-Today>

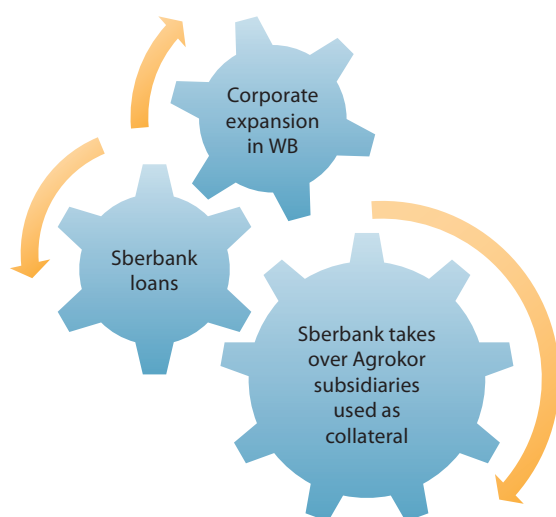
⁹⁰ Ilic, Igor. "Croatia passes law to protect economy from Agrokor-like crisis," Reuters, April 6, 2017.

⁹¹ "Rusija više neće davati kredite Agrokoru – Hrvatski koncern moraće da vrati pozajmljeni novac," E-Kapija, February 11, 2017, <http://www.ekapija.com/news/1669550/rusija-vise-nece-davati-kredite-agrokoru-hrvatski-koncern-morace-da-vrati-pozajmljeni>

⁹² "Vučić pred susret s Putinom: Sberbank preuzima 52 % udjela u Agrokoru," SEEBiz, March 26, 2017, <http://www.seebiz.eu/vucic-pred-susret-s-putinom-sberbank-preuzima-52-udjela-u-agrokoru/ar-153125/>

In an attempt to consolidate Agrokor, in March 2017, Sberbank gathered four other creditors (Privredna banka Zagreb, Reifeisen banka Austrija, VTB Banka Austrija AG, and Zagrebacka banka) and issued one large syndicated loan with the condition that Agrokor appoint new management, consisting of independent experts. At the same time, Croatia adopted a special law that would restructure the management of companies with systemic importance for the economy (later dubbed “Lex Agrokor”), with the immediate purpose of stabilizing Agrokor. This law effectively prevented a potential Sberbank takeover of Agrokor. This was likely part of the talks between President Grabar-Kitarović of Croatia and President Putin in Sochi on October 19, 2017.⁹³

Figure 9. The wider economic vulnerability that the Agrokor case presents



“Lex Agrokor” imposes compulsory state administration for companies with more than 5,000 employees and debt levels higher than EUR one billion, depending on the company’s loan agreement. Slovenia’s Parliament similarly introduced “Lex Mercator” to protect the use of the Slovenian subsidiary of Agrokor to cover Agrokor’s debt. Croatia installed a special administration in early 2017 to run the company for the following 15 months. The new management succeeded in persuading a fund of American Knighthead Capital Management (AKCM) specializing in distressed companies to secure a EUR 480 million loan to Agrokor. Sberbank rejected the

deal and proceeded to claim its Serbian and Bosnian assets, which had been used as securities for its loan to Agrokor. However, the Serbian Commercial Court did not allow Lex Agrokor to apply to the subsidiaries in Serbia. Consequently, Sberbank was able to begin a lawsuit claiming its Serbian assets as loan guarantees in July-August 2017. The Serbian court decided to rule against Lex Agrokor in order to protect Serbian companies from potential bankruptcy during a resale.

Clearly, the Agrokor crisis has the potential to critically affect the Serbian economy. In Serbia, Agrokor owns a supermarket chain (made up of three brands), a retail credit card company, pastry and ice cream companies, a mineral water and sunflower oil producer, real estate management companies, and various consultancies. Agrokor directly employs 11,200 workers, or 16 percent of all employees of Russian-controlled or -related

⁹³ Samorukov, Maxim. (2017). “Croatia: Moscow’s New Ally, or a Brief Fling?” Carnegie Moscow Center. October 27, 2017, accessed on December 4, 2017 at <http://carnegie.ru/commentary/73562>

companies in the country.⁹⁴ Merkator-S, which is the second biggest retailer in Serbia with around EUR 867 million in revenue in 2016, has 350 diverse supermarkets under its purview, making it one of the largest companies in Serbia in terms of turnover and employees. The company works with at least 660 domestic suppliers with enormous significance for small-town economies.

Not surprisingly, Serbia pledged to prevent companies under Agrokor's ownership from suffering any direct damage and in April 2017 announced that it would introduce temporary measures in commercial courts to protect these companies.⁹⁵ Following this statement, Sberbank filed multiple requests in Serbian commercial courts to block the disposition of companies' property related to Agrokor. Serbian law prevents a foreign-owned parent company from guaranteeing loans with the property of subsidiaries in Serbia. This effectively supported the Sberbank request. The courts introduced additional temporary measures that forbid creditors of Agrokor companies from expatriating affected Serbian property.

During the Agrokor crisis, the Serbian mainstream media however reported that several businesspeople who could be connected to Russia were interested in taking over the ailing subsidiaries in Serbia.⁹⁶ Rodoljub Draskovic, a brother-in-law of Danica Draskovic, a current member of the Board of Directors of NIS, is one of the most prominent of these individuals. Because Sberbank has indicated that it would not like to run the Agrokor subsidiary businesses itself, it is possible that the Russian financial institution will sell them to private owners. So far, the Serbian government and the courts have assisted Sberbank in its fight for control of Agrokor's assets. By allowing asset transfers to companies with ties to Russia, Moscow could potentially penetrate deeper into the Serbian economy. The extensive reach of Mercator-S into the Serbian economy could represent a future vulnerability.

The restructuring of Agrokor would also necessarily have an effect on its Bosnian subsidiaries, including one of the largest retail chains, Konzum, which recorded revenue of EUR 434 million in 2015 and employed 4,154 people in Bosnia and Herzegovina. Agrokor has a total of eight subsidiaries in Bosnia and Herzegovina, with a total of over 5,000 employees.

Konzum's potential sale could have a domino effect of failing suppliers. It has more than 100 suppliers, including large meat and dairy plants.⁹⁷ Konzum owes them around EUR 66.5 million. So far, these suppliers have agreed to cooperate with Agrokor in a debt-restructuring program that

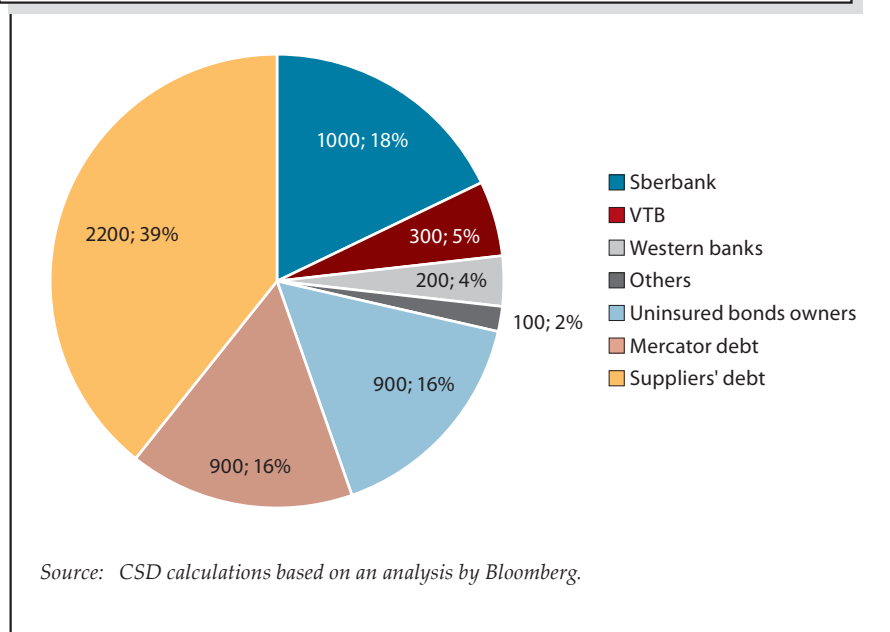
⁹⁴ "Seratlić poručio Ljajiću: Mercator S plaća sve na vreme," SEEbiz, March 23, 2017, <http://rs.seebiz.eu/seratlic-porucio-ljajicu-mercator-s-placa-sve-na-vreme/ar-152959/>

⁹⁵ "Vučić o Agrokoru: Evo šta možemo da uradimo," Mondo, April 19, 2017, <http://mondo.rs/a1000962/Info/Ekonomija/Agrokor-Vucic-i-ministri-iz-regiona-zasedaju.html>

⁹⁶ BIZLife (2017). "Rodoljub Draskovic offering Todoric to take over Agrokor's operations in Serbia." Reprinted on the online media portal Ekapija on April 27, 2017, accessed on January 2, 2017 at <https://www.ekapija.com/en/news/1742166/rodoljub-draskovic-offering-todoric-to-take-over-agrokors-operations-in-serbia>

⁹⁷ Among the biggest suppliers are the following companies: Coca Cola, AS Jelah Group, Atacco, Violeta, Orbico, Megamix, Milkos, Meggle, Akova, Perutnina Ptuj and Bimal Brcko.

Figure 10. Structure of Agrokor's Debt by Source – EUR million and share (%)



started in September 2017.⁹⁸ In May 2017, Agrokor decided to put its Slovenian subsidiary, Mercator, in charge of the holding's business in Bosnia and Herzegovina, amid complaints by suppliers of not receiving regular payments for their deliveries.⁹⁹ The deal specifies that Mercator will take over 83 of 253 stores operated by Agrokor in the country.¹⁰⁰ Konzum also received a EUR 120 million injection from its fellow Agrokor subsidiaries in the country, which should be used to restructure the company's debts to suppliers.¹⁰¹ Agrokor also agreed to restructure into Konzum shares EUR 34.6 million in claims of two other Agrokor subsidiaries in Bosnia and Herzegovina, Ledo Čitluk and Sarajevski Kiseljak. In addition, Konzum Sarajevo is set to receive a EUR 15 million loan from the main Agrokor holding.¹⁰²

The Agrokor affair demonstrates one instance of Sberbank's expanding control over the retail sector in the Western Balkans. Apart from

⁹⁸ Pavlin, Vedran (2017). "Agrokor's Suppliers in Bosnia Ready to Continue Cooperation," Total Croatia News. April 17, 2017, accessed on December 1 at <https://www.total-croatia-news.com/business/18266-agrokor-s-suppliers-in-bosnia-ready-to-continue-cooperation>

⁹⁹ Garaca, Maja (2017). "Croatia's Agrokor to focus on Bosnia due to problems with suppliers – receiver," SeeNews, June 23, 2017, accessed on December 1 at <https://seenews.com/news/croatias-agrokor-to-focus-on-bosnia-due-to-problems-with-suppliers-receiver-573396#sthash.dHX6xrKo.dpuf>

¹⁰⁰ Garaca, Maja (2017). "Retailers Mercator, Konzum to operate side by side in Bosnia from August 1," SeeNews, July 13, 2017, accessed on December 1 at <https://seenews.com/news/retailers-mercator-konzum-to-operate-side-by-side-in-bosnia-from-august-1-575914#sthash.Q0dzM4Ow.dpuf>

¹⁰¹ Garaca, Maja (2017). "Croatian retailer Konzum's Bosnian unit eyes 15 mln euro capital injection – report," SeeNews, August 15, 2017, accessed on December 1 at <https://seenews.com/news/croatian-retailer-konzums-bosnian-unit-eyes-15-mln-euro-capital-injection-report-579744#sthash.4sEDnyv6.dpuf>

¹⁰² ESM (2017). "Agrokor To Recapitalise Konzum In Bosnia & Herzegovina," September 4, 2017, accessed on December 1, 2017 at <https://www.esmmagazine.com/agrokor-recapitalise-konzum-bosnia-herzegovina/48608>

this case, a number of reports implicated Sberbank in the alleged facilitation of a suspected money laundering operation in 2012, which involved a majority share acquisition of Bosnia's largest pharmaceutical company, Bosnalijek,¹⁰³ by a Luxembourg-registered offshore fund, Haden.¹⁰⁴ Sberbank gave a EUR four million loan to Haden to finance the costs of purchasing Bosnalijek shares without reporting the operation to the Department for Combating Money Laundering and the Financing of Terrorism, and the Financial and Intelligence Department of the State Investigative and Protection Agency in Bosnia and Herzegovina (SIPA).¹⁰⁵ The bank supervision agency filed a criminal complaint against Sberbank for not disclosing the loan to Haden and the facilitation of another transfer of USD 5.76 million from Luxembourg to Haden's account in Sberbank's Sarajevo branch. Bosnia's prosecutor began an investigation into a possible money-laundering scheme, but after two years of proceedings, no indictments were filed against Sberbank. Some observers felt that the failure to file charges reflected the low level of capacity of investigators in Bosnia and Herzegovina to tackle complex cross-border cases.

Haden has also been associated in some reports with a large Russian pharmaceutical supplier, Imperia Pharma. Haden purchased 52 percent of Bosnalijek in two separate transactions through the Bosnian stock exchange for an estimated EUR 20 to 25 million.¹⁰⁶ Following the entry of Imperia Pharma into Bosnia and Herzegovina, Bosnalijek increased its share, since 2013, in the Bosnian drug maker to over 50 percent. Currently, Bosnalijek sells 150 products in 14 countries in Southeast Europe, Russia, and some former Soviet republics, with revenue of EUR 78 million, close to 90 percent of which is generated in Russia.¹⁰⁷ This excessive dependence on the Russian market could prove to be a vulnerability for the largest Bosnian drug maker. For example, following Montenegro's joining NATO and its decision to align with the EU on sanctions, Russia banned wine imports from the state-owned Plantaze plant, which had generated most of its sales in Russia.¹⁰⁸

Money laundering risks have long dogged the Bosnian banking system. SIPA previously raided several small banks in RS and arrested 10 financiers and bank regulatory officials, accusing them of colluding to facilitate corruption.¹⁰⁹ The affected banks were Bobar, Pavlovic, and Banka

¹⁰³ According to a 2013 IHS Markit study, Bosnalijek is the second largest pharmaceutical supplier in Bosnia and Herzegovina with around USD 21 million out of a USD 366 million market. The company's market position has improved significantly over the last couple of years as its revenues jumped to close to EUR 80 million after its entry into Russia and Turkey.

¹⁰⁴ Center for Investigative Reporting (2016). Fishy Transactions from Russia via Sberbank. CIN, September 14, 2016.

¹⁰⁵ Ibid.

¹⁰⁶ "Luxembourg Haden increases its stake in Bosnia's largest drugmaker," Pharmaletter, August 3, 2013.

¹⁰⁷ "Bosnalijek to establish production of drugs in Russia," Pharmaletter, July 7, 2017.

¹⁰⁸ Associated Press (2017). Montenegro says Russia banned its wine over NATO accession. April 27, 2017, accessed on January 5, 2018 at <http://abcnews.go.com/amp/International/wireStory/montenegro-russia-banned-wine-nato-accession-47054642>

¹⁰⁹ Nuttall, Clare (2016). "Investigations reveal rotten side of Bosnian Republika Srpska's bank sector," BNE Intellinews, May 13, 2016, accessed on November 16 at <http://www.intellinews.com/investigations-reveal-rotten-side-of-bosnian-republika-srpska-s-bank-sector-97327/>

Srpske, among others. According to a report of the High Representative, Bobar's bankruptcy in 2014 (following the diversion of its funds) affected many public institutions, companies, and individuals.¹¹⁰ The scandal also involved RS President Dodik, who was accused by Bosnia's Special Prosecutor of borrowing 750,000 EUR from Pavlovic Bank with a fictitious loan to purchase a luxury villa in Belgrade.¹¹¹

Russian companies have not limited their regional expansion to the banking and energy sectors. Large-scale acquisitions and significant capital inflows have been registered in the gambling, metallurgical, mining, real estate, and tourism sectors.

Mining and Metallurgy

To date, Russia's biggest and most strategically important investment in the Western Balkans is the 2005 takeover of two state-owned industries in Montenegro just prior to independence. Oleg Deripaska's Rusal paid EUR 58.5 million for 65.4 percent of KAP and 32 percent of the Niksic bauxite mine. This agreement included the obligation that Deripaska repay EUR 90 million of the two state-owned companies' legacy debt. Part of the privatization agreement stipulated that KAP receive electricity at preferential terms and prices from the state-owned power supplier, EPCG, until 2010.¹¹²

After the electricity deal with EPCG expired, Rusal sought additional subsidies. Following the end of the preferential deal, the Russian owner of KAP attempted to obtain additional electricity subsidies after the expiration of its contract with the EPCG. It appeared that Deripaska's plan was to ensure long-term electricity supply to the aluminum plant by also buying the only thermal power plant (TPP) and coal mine in Pljevlja, offering EUR 45 million for the TPP and EUR five million for the coal mine. Controlling the whole power supply chain would reduce KAP's energy costs and provide the plant with uniform control over one of the most important inputs in aluminum production. The merger and acquisition was stopped by Parliament in June 2007 after a small group of MPs from the ruling party joined forces with the opposition to block the deal. Since its privatization, KAP has been the biggest consumer of electricity in Montenegro, at nearly two billion kWh (two TWh) annually, or close to half of the country's total power demand.

The 2009 global economic crisis had an enormous impact on Deripaska's businesses, with reportedly billions in losses. Especially hard hit was the aluminum industry, including KAP and Rusal. KAP generated enormous losses, and the company reduced the number of employees from 2,116 in 2007 to 1,344 in 2010. It appears that the Russian owner expected the Mon-

¹¹⁰ Ibid.

¹¹¹ OCCRP (2016). Bosnia and Herzegovina: Police Bust Bank Owner Linked to RS President Dodik. February 13, 2016.

¹¹² The power sale contract with the EPCG, which was valid until 2010, envisaged that in its first three years, KAP would receive two-thirds of the electricity under a preferential regime, while in the next two years, only half of the power would be bought for a discounted price.

tenegrin state to support the restructuring of KAP, following the logic of “too big to fail.”

CEAC and the government signed a new agreement in October 2010, according to which the Montenegrin state regained 29.36 percent of KAP and 31.45 percent of the bauxite mine. CEAC kept the management rights, and the government of Montenegro appointed board members with veto powers in both companies.¹¹³ Through the contract, Montenegro provided KAP with a state guarantee in the amount of EUR 135 million that would back new loans taken by the aluminum plant. In essence, the Russian owner of KAP received the exact terms requested – state loan guarantees, state debt forgiveness,¹¹⁴ a cut in the number of employees, and an additional EUR two million provided to KAP by the state budget for covering severance compensation. However, KAP did not secure a preferential electricity price.

In February 2011, Hungary’s OTP bank informed the government that the state guarantees would be activated, as KAP had not paid one of its credit installments. As a result, the Montenegrin government pursued action against the owners of KAP, which culminated with an order issued by the Ministry of the Economy to prepare for a state takeover of KAP, as the aluminum plant had failed to pay its electricity bills or the debts guaranteed by the state.¹¹⁵

As bankruptcy proceedings began, CEAC initiated arbitration against the state of Montenegro, demanding compensation for EUR 100 million. KAP also expressed a willingness to reach an out-of-court settlement, apparently reasoning that such a decision would be beneficial for all sides, and especially for Montenegrin taxpayers. CEAC argued that the Montenegrin state violated several obligations set out in the privatization agreement and, although it did not announce the exact value of the dispute, it claimed that it would demand compensation for over EUR 600 million.¹¹⁶

¹¹³ This did not prevent KAP from allegedly stealing 190.515 MWh of electricity worth EUR 9.6 million from the European interconnection mechanism in 2013, which was later paid by Montenegrin taxpayers. The electricity taking went through another state-owned company, Montenegrin Electric Transmission (CGES), which is further indication that this likely could not have happened without collusion with state actors.

Rapoza, Kenneth. (2015). “This Crazy Country Is Picking A Fight With A Billionaire Worth 80 percent Of Its GDP”. *Forbes*, November 29, 2015, accessed on January 21, 2018 at <https://www.forbes.com/sites/kenrapoza/2015/11/29/this-country-pickingfight-with-a-russian-billionaire-who-is-worth-80-of-its-gdp/#6181f34574c8>

ENTSO-E. (2013). Montenegrin TSO CGES Asked to Balance its System and Compensate TSOs for Power Flows. June 7, 2013, accessed on January 21, 2018, at <https://www.entsoe.eu/news-events/announcements/announcements-archive/Pages/News/montenegrin-tso-cges-asked-to-balance-its-system-and-compensate-tsos-for-power-flows.aspx>

Prelec, Marco. (2014). *Winners and Losers: Who benefits from high-level corruption in the South East Europe energy sector?* SEE Change Net, June, 2014, accessed on January 18, at <http://www.mans.co.me/wp-content/uploads/2014/06/SEE-energycorruption.pdf>

¹¹⁴ Including debts for unpaid income taxes for 2006 and 2007, as well as almost EUR 15 million of unpaid taxes on employees’ salaries.

¹¹⁵ In early 2012, KAP owed EUR 28 million for electricity to EPCG with little prospect of repayment.

¹¹⁶ Tomovic, Dusica. (2016). *Russian Tycoon Sues Montenegro Over Aluminum Plant*. *BalkanInsight*. November, 15, 2016.

So far, CEAC has lost two arbitration cases against Montenegro – one at the United Nations Commission on International Trade Law (UNCITRAL) arbitration tribunal (January 2017)¹¹⁷ and one at the International Center for Solving Investment Disputes (ICSID) (July 2016).¹¹⁸ At the end of 2016, Deripaska filed a lawsuit in a Cypriot court against Montenegro,¹¹⁹ claiming that, following his significant and well-timed investment in KAP and the bauxite mine, the Montenegrin state undertook a series of hostile measures to expel him from the company's ownership. He asserted that Montenegro denied his investments fair and equal treatment, contrary to international law and contractual obligations.

The role of Russian companies in the mining and metallurgical sectors in Montenegro has revealed key governance deficits associated with privatization throughout the Western Balkans. KAP's Russian owner took advantage of the government to obtain loan guarantees that were not supported by a proper economic assessment. A 2013 report by the State Audit Institution (SAI)¹²⁰ of Montenegro concluded that KAP received loan guarantees without appropriate counter-guarantees, exposing the state to significant financial risk. State auditors further determined that state guarantees to KAP lacked a detailed cost-benefit analysis of the company's financial status, as well as an analysis of the sustainability of its planned restructuring. SAI determined that the Economy and Finance ministries, as well as the State Aid Regulatory Commission, did not conduct a due diligence assessment of the financial position of KAP, and did not consider the findings of private auditors. SAI's report claimed that financial indicators had demonstrated that KAP could not pay back the loans from its own resources, placing the profitability of the plant in question.

All guarantees that the Government gave to KAP were eventually paid by taxpayers. The lack of a detailed financial assessment of this foreign investor's capacity to purchase the largest company in the country and implement the investment requirements specified in the initial agreement contributed to later controversies surrounding the renegotiation of the contract between the state and KAP's Russian owner.

In Macedonia, there are similar deficits in governance. Jugohrom, an electrical and metallurgy plant owned by a chain of Cypriot- and Hong Kong-based offshore companies controlled by Russians Maxim Moskalev and Dimitry Agramakov,¹²¹ has racked up violations of environmental standards that have turned the city of Tetovo into one of the most

¹¹⁷ Government of Montenegro, Press release, "Arbitral Tribunal in Vienna rules: All CEAC claims against Montenegro rejected," January 13, 2017, <http://www.gov.me/en/News/168376/Arbitral-Tribunal-in-Vienna-rules-All-CEAC-claims-against-Montenegro-rejected.html>

¹¹⁸ Government of Montenegro, Press release, "CEAC loses arbitration against Montenegro, has to bear arbitration costs," July 27, 2016, <http://www.gov.me/en/News/163686/CEAC-loses-arbitration-against-Montenegro-has-to-bear-costs-of-trial.html>

¹¹⁹ "Deripaska's suit against Montenegro falls under investment protection pact – CEAC", TASS, December 8, 2016, <http://tass.com/economy/917849>

¹²⁰ Državna revizorska insitucija, Izvještaj o reviziji: Državne garancije Vlade Crne Gore izdate u 2010. i 2011, April 29, 2013, <http://www.dri.co.me/1/doc/01-Konacni%20izvjestaj%20za%20garancije%2029.04.KONACNA%20VERZIJA%20DRI.pdf>

¹²¹ Xhelal, Neziri. (2015). "In the toxic kingdom of Jugohrom," Center for Investigative Journalism – SCOOP, February 21, 2015, accessed on November 21, 2017 at <http://en.scoop.mk/in-the-toxic-kingdom-of-jugohrom/>

polluted places in Europe. The plant is one of Macedonia's top employers, with 1,100 workers, and top exporters, accounting for seven percent of all exports. Still, for years, Jugohrom has faced little supervision and few consequences. Despite prior investigation by the Tetovo public prosecutor and an indictment in 2014 against the management of Jugohrom on charges of endangering the health of the citizens of Tetovo, the case was dropped on December 5, 2014 due to a lack of evidence of any criminal offense.¹²² This changed when the company failed to meet an October 31, 2016 deadline set by the State Inspectorate for the Environment to install a dust collection system, and was, as a result, closed.¹²³

Russia's economic footprint also extends to other Macedonian companies. From 2005 to 2015, the company Solway – which is officially registered in Switzerland, but has links to Deripaska's Rusal holding¹²⁴ – owned Sasa, a lead-zinc and copper mine, and Bucim, the most productive copper and gold mine in the country. Solway's investments in the development and expansion of the mines was estimated at EUR 70 million through December 2015, when it sold Sasa to a US-based commodities fund. Solway now operates only the Bucim mine.¹²⁵

Real Estate, Tourism and Sports

Deripaska's arrival in Montenegro at the end of 2005 sparked feverish investment in the real estate and tourism industries, including plans for a series of multi-million-dollar resorts along the Adriatic coast.¹²⁶ Tourism makes up around one-fifth of Montenegrin GDP and over 54 percent of the export of goods and services.¹²⁷ It is a strategic sector of the Montenegrin economy, and forecasts from the World Travel & Tourism Council (WTTC) show that by 2026, tourism could constitute up to 30 percent of the country's GDP.¹²⁸ Russian tourists are the largest group of visitors to Montenegro, amounting to 25 percent of the total.¹²⁹ Since 2006, the number of Russian tourists has jumped five-fold, to 316,000 in 2016, spending a total of 2.87 million nights. At an average price per night of around EUR 70, one could estimate that in 2016 alone, Russian tourists spent a

¹²² Xhelal, Neziri (2015). "In the toxic Kingdom of Jugohrom", Center for Investigative Journalism – SCOOP, February 21, 2015, accessed on November 21 at <http://en.scoop.mk/in-the-toxic-kingdom-of-jugohrom/>

¹²³ Dimitrievska, Valentina (2016). "Top Macedonian exporter Jugohrom faces shutdown over air pollution". IntelliNews, November 1, 2016.

¹²⁴ Smith, Geoffrey. (2017). "What to Know About Oleg Deripaska, the Russian Billionaire Who Paul Manafort Worked For" Time Magazine, March 22, 2017.

¹²⁵ MiningSee. (2015). "Orion mine finance, the owner of Macedonia Sasa lead zinc optimistic in commodities market," December 7, 2015, accessed on November 16, 2017 at <https://www.miningsee.eu/orion-mine-finance-the-owner-of-macedonia-sasa-lead-zinc-optimistic-in-commodities-market/>

¹²⁶ Ames, Mark and Berman, Ari. (2008). "McCain's Kremlin Ties," The Nation. October 1, 2008, accessed on December 4, 2017 at <https://www.thenation.com/article/mccains-kremlin-ties/>

¹²⁷ "Predrag JELUŠIĆ: Turizam daje petinu BDP-a i čini više od polovine izvoza Crne Gore," *Portal Analitika*, September 27, 2015, <http://www.portalanalitika.me/clanak/203071/predrag-jelusic-turizam-daje-petinu-bdp-a-i-cini-vise-od-polovine-izvoza-crne-gore>

¹²⁸ Ministry of Tourism and Sustainable Development, Intervju: Prihodi od turizma u 2016. biće veći od 850 miliona eura, September 29, 2016, <http://www.mrt.gov.me/vijesti/165472/Prihodi-od-turizma-u-2016-bice-veci-od-850-miliona-eura.html>

¹²⁹ "Četvrtina turista u Crnoj Gori su Rusi," *Bankar.me*, May 20, 2017, <http://www.bankar.me/2017/05/20/cetvrtina-turista-u-crnoj-gori-su-rusi/>

little over EUR 200 million only on accommodations, which is around five percent of GDP.¹³⁰

The deterioration of bilateral relations since 2014 has had a negative impact on the flow of Russian tourists to Montenegro. The Russian government tried to accelerate this trend by discouraging its citizens from spending vacations in Montenegro. Russian Foreign Minister Sergey Lavrov said in March 2017 that Montenegro is sacrificing its economic relations with Russia by joining NATO.¹³¹ A negative Russian media campaign describing Montenegro as dangerous for Russian citizens followed the statement. Media reports pointed to increased crime, filthy beaches, and a difficult tourist season.¹³² The negative publicity campaign seems to have had an effect. Although Russians accounted for the largest group of tourists in Montenegro in June 2017 (25.2 percent), their number fell from 49,666 to 18,845 year-on-year.¹³³

The Russian economic presence in Montenegro's tourism sector consists of more than tourists. In the privatization process after 2006, Russian business owners and companies acquired several Communist-era hotels in attractive locations. There is no comprehensive analysis of the entirety of Russian investment in tourism, but local media and independent civil society organizations have worked to document attempted Russian investments that sought to use Montenegro's governance deficits to facilitate deals. In several cases, Russian firms that appeared to be shell companies with little capital won large privatization tenders without being able to fulfill the government's requirements for modernization, as agreed in the privatization deals. In several notable cases, despite failing to implement the privatization agreements, there have been little or no consequences for the Russian investors involved.

One example is the privatization of the Lido Hotel in Ulcinj. In 2006, a Budva-based Russian-owned company, Capital Estate, won a tender to purchase the hotel with an offer of EUR 10.8 million, promising another EUR 38 million in investment. The company paid the tender bid but failed to commit the additional investment.¹³⁴ Despite calls from local authorities to terminate the agreement with Capital Estate, the government legiti-

¹³⁰ The estimate is based on the average revenue per room rate in the 2014 Horwath Hotel Industry Survey Montenegro, commissioned by the Montenegrin government, accessed at <http://www.mrt.gov.me/ResourceManager/FileDownload.aspx?rid=221725&rType=2&file=Poslovanje%20hotelijerstva%20u%20Crnoj%20Gori%202014..pdf>

¹³¹ "Unclear How Montenegro NATO Accession to Boost Alliance's Security – Lavrov," *Sputnik*, March 23, 2017, <https://sputniknews.com/military/201703231051876080-montenegro-nato-accession/>

¹³² "Криминал, минные поля и столбняк: почему Черногория становится опасной для туристов," *TV Zvezda*, March 25, 2017, https://tvzvezda.ru/news/vstrane_i_mire/content/201703251100-mpeq.htm

"Альянс наготове: Черногория в одном шаге от вступления в НАТО," *TV Russia1*, March 28, 2017, <http://www.vesti.ru/doc.html?id=2871302>

"Захарова: МИД РФ рекомендует россиянам дважды подумать, прежде чем ехать в Черногорию," *Tass.ru*, May 29, 2017, <http://tass.ru/politika/4291514>

¹³³ *Intellinews* (2017). "Tourist numbers up in Montenegro but Russians stay away," July 31, 2017.

¹³⁴ "Capital Estate: Port Milena na sprječava da ispunimo svoje obaveze," *Vijesti.me*, March 24, 2012, <http://www.vijesti.me/ekonomija/capital-estate-port-milena-nas-sprjecava-da-ispunimo-svoje-obaveze-66186>

mized the investment delay by annexing the contract.¹³⁵ The hotel was demolished in 2013, but a new hotel has not yet been built. Another example was the construction of a hotel complex in Maljevik, in Bar Municipality, by the Cyprus-registered Sonuba Montenegro, which was later in 2010 acquired by the Russian Mercury Group.

Another questionable practice in Montenegro's real estate sector involves the sale of attractive pieces of state-owned land for below-market prices. Russian companies have been involved in such deals. One example is the sale of the former military complex Skocidjevojka in Budva. The property was sold before Montenegrin independence for EUR 2.35 million, while the land was later resold for EUR 41.7 million. The deal involved Russian-owned companies registered in Montenegro and offshore registered companies owned by Montenegrin businessmen.¹³⁶ Claiming that the government lost tens of millions of euros in the deal, the anti-corruption non-profit MANS brought a complaint naming the then-Minister of Finance in 2012,¹³⁷ but there is no information that an investigation was ever opened.

Some Russian investments are now under investigation by Montenegro's Office of the Special Prosecutor for Organized Crime and Corruption.¹³⁸ One case that did result in a criminal conviction was the construction of a resort in Cape Zavala, near Budva, in 2008. Mirax Group, owned by Russian businessman Sergey Polonsky, started the project together with Svetozar Marovic, the then-Vice President of the Montenegrin ruling party, the Democratic Party of Socialists of Montenegro (DPS), whose family was among the most influential in the town of Budva. Mirax announced it would construct an exclusive tourist resort on the Zavala Cape, including villas and luxury hotels that were to resemble the Burj al Arab in Dubai. The project was partially financed by the First Bank, controlled by the brother of then-Prime Minister Milo Djukanovic.¹³⁹ Construction continued from 2008 to 2009 without a permit, until financial problems brought the project to an abrupt halt.

¹³⁵ "Vladi šamar iz Ulcinja," ND Vijesti, March 7, 2011.

¹³⁶ The main buyers of the property were the Russian company Opora and the Montenegrin company Spartak, represented by Nikolay Zemlyanskyi and Alexander Belyakov. Two months before signing the purchase agreement, the buyers established a new company in the Seychelles – Blaze Corporation – which was used to pay the purchase price of 2.35 million euros. Two years later, in 2007, Skocidjevojka was sold to a Cyprus-registered company, Caldero Trading Limited, owned by Montenegrin businessman Zoran Becirovic, for EUR 14 million. Within seven days, he resold the complex to Palestinian businessman Mohamed Borhan Rachid for EUR 41.7 million. In 2015, the Hipo Alpe Adria Development company announced a public tender for the property, because Rachid's company, Monte Mena, was unable to pay back a EUR 5.28 million loan used for the purchase of the property. Later, Austria's Meindl Bank AG acquired the resort for EUR 7.3 million.

Milovac, Dejan and Mrdovic, Ines. *Urban Planning: Captured by Corruption – Case Studies from Montenegro 2011/2012*. MANS. Podgorica, 2012.

¹³⁷ "Prodajom Skočidjevojke država oštećena za desetine miliona," *Vijesti.me*, July 7, 2012, <http://www.vijesti.me/ekonomija/prodajom-skocidjevojke-drzava-ostecena-za-desetine-miliona-82917>

¹³⁸ For example, the purchase of Hotel As, in Petrovac by the Russian-Montenegrin company Nega Tours; the construction of the luxury tourist settlement Tsarskoye Selo (Imperial Village) near Budva by the Moscow-based Tradeunique holding company; and the purchase of Hotel Otrant in Ulcinj by the Russian company Barkli SK.

¹³⁹ Organized Crime and Corruption Reporting Project. (2012). *Zavala: Cape Corruption*. OCCRP, June 11, 2012, accessed on January 14, 2018 at <https://www.reportingproject.net/firstbank/en/zavala-cape-corruption>

In April 2008, MANS brought a complaint to the Supreme State Prosecutor naming the key actors in the Zavala affair: DPS Vice President Svetozar Marović, Secretary for Investment for the Municipality of Budva Dragan Marović, and the Executive Director of Mirax Balkan, Vječaslav Lejbman. After nearly two years of investigation, the prosecution indicted 10 local officials from the Budva municipality, including the mayor of Budva, Rajko Kuljaca, and his deputy, Dragan Marovic, who is also a brother of Svetozar Marovic.¹⁴⁰ Finally, in 2016, the Appellate Court of Montenegro sentenced Kuljaca to two and a half years in prison, together with the former Municipal Secretary for Investments Dragan Marovic, who received two years. They were found guilty of abuse of office and damage to the municipal budget of EUR 820,000 to the benefit of Zavala Invest, a subsidiary of the Russian Mirax company. Eight other municipal employees received eight years of prison sentences in total.¹⁴¹

During the peak era (2011 – 2014) of Russian investment after Montenegrin independence, Russian nationals bought numerous apartments and houses on the coast, causing real estate prices to skyrocket. Numerous media reports speculated that these sales were used for money laundering, but no official confirmation was ever provided.¹⁴² Since independence, Russian nationals have paid close to EUR 25 million in real estate sales taxes. Official data on the amount of real estate owned by Russians is not publicly available, as real estate registries do not provide aggregate data search options, but one number circulated in the media is 70,000 properties.¹⁴³ The lack of data and transparency makes it difficult to conduct an objective analysis of the exact volume of capital flowing into the country's real estate sector, which prevents financial intelligence bodies and tax inspectorates from uncovering potential schemes to launder money and evade taxes.¹⁴⁴ Montenegro's enormous exposure to Russian investment, combined with the significant amount of real estate holdings in Russian hands, could very well influence the country's foreign and security policies. Still, the number of small actors in the real estate sector means that the Russian presence is dispersed, a sort of safeguard that makes it difficult, albeit not impossible, for Russia to exert direct control over the real estate sector.

Meanwhile, estimates of the number of Russian nationals that permanently reside in Montenegro vary. According to a 2011 census, around 1,000

¹⁴⁰ MANS, Zavala – the case study, 2008 – 2011. <https://www.reportingproject.net/firstbank/en/documents/finish/13-zavala-cape-corruption/83-zavala-13>

¹⁴¹ Radevic, Komnen. (2016). "Rajku Kuljaci got two-and-a-half and Dragan Marovic two years in prison", *Vijesti*, December 16, 2016, accessed at <http://www.vijesti.me/vijesti/rajku-kuljaci-dvije-i-po-draganu-marovicu-dvije-godine-zatvora-916506>

¹⁴² OCCRIP (2011). "Russian Elites Pay Millions for Real Estate in Montenegro," November 30, 2011.

O'Farrell, Michael, and Patrucic, Miranda. "Montenegrin Prosecutors Launch Probe Into Irish Investment," August 20, 2013.

Сухотин Андрей и Аниң, Роман (2011). "Montenegrin Gnomes," *Novaya Gazeta*, November 28, 2011.

Bilefsky, Dan. (2008). "Despite Crisis, Wealthy Russians Are Buying Up Coastal Montenegro," *The New York Times*, October 31, 2008.

¹⁴³ "Rusi su u Crnoj Gori kupili 70.000 nekretnina," *Vijesti.me*, May 17, 2014, <http://www.vijesti.me/vijesti/rusi-su-u-crnoj-gori-kupili-70000-nekretnina-21034>

¹⁴⁴ Many of the more than 1,700 microenterprises owned by Russian citizens in Montenegro have been set up due to the country's requirements for purchasing real estate property or a motor vehicle.

inhabitants declared themselves Russians or Russian speakers.¹⁴⁵ According to a 2014 statement by the Russian Ambassador, there are up to 7,000 Russians permanently residing in Montenegro,¹⁴⁶ while estimates of Russian-speaking diaspora go up to 15,000.¹⁴⁷ Russian permanent residents own small businesses, such as restaurants, shops, and tourist agencies; in several primary schools their children are taught in Russian-language classes.

Box 1. Russian investment in the Macedonian real estate and sports sectors

When discussing the nature of Russian capital flows in the Western Balkans, one of the best examples is Samsonenko's business in Macedonia. Samsonenko is a Russian businessman who came to Macedonia just a few months after Gruevski became Prime Minister in the fall of 2006. Beginning then and continuing to the present, Samsonenko has had links with the then-ruling coalition of the Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity (VMRO-DPMNE).¹⁴⁸ First, a former VMRO Member of Parliament (MP) (1998 – 2002), Aleksandar Pandov, worked as a manager in Samsonenko's BetCity gambling business until 2011.¹⁴⁹ Second, Samsonenko publicly appeared in a pre-election music video commissioned by VMRO-DPMNE in 2014, in which he openly supported Gruevski. Samsonenko's investments have been concentrated in sports and gambling. In addition to BetCity, Samsonenko owns the football and handball club Vardar. His biggest direct investment in the country is a 2014 public-private partnership between one of his companies and the municipality of Aerodrom (at that time governed by a VMRO-DPMNE mayor) to build "Sport Center Jane Sandanski." The municipality gave Samsonenko a 35-year concession for the sports hall in a fully non-competitive non-transparent procedure. The company managing the sports hall¹⁵⁰ is a Cypriot-based offshore company owned ultimately by a Belize-based shell company used by Samsonenko for many of his other investments. In addition to Samsonenko's businesses, many companies associated with political elite close to Gruevski are registered at the same addresses in the offshore havens used by Samsonenko himself.¹⁵¹

¹⁴⁵ Official data by MONSTAT, Census of Population, Households and Dwellings in Montenegro 2011, July 2011.

¹⁴⁶ "Nesterenko: U Crnoj Gori živi do sedam hiljada Rusa," *Vijesti.me*, January 27, 2014, <http://www.vijesti.me/vijesti/nesterenko-u-crnoj-gori-zivi-do-sedam-hiljada-rusa-174290>

¹⁴⁷ "Rusi su u Crnoj Gori kupili 70.000 nekretnina," *Vijesti.me*, May 17, 2014, <http://www.vijesti.me/vijesti/rusi-su-u-crnoj-gori-kupili-70000-nekretnina-21034>

¹⁴⁸ Lefkov, Goran (2016). "Samsonenko: Successful in Macedonia-under scrutiny in Russia". Center for Investigative Journalism – SCOOP, December 5, 2016.

¹⁴⁹ SCOOP (2016). "Samsonenko: Successful in Macedonia-under scrutiny in Russia," Center for Investigative Journalism – SCOOP, December 5, 2016 accessed on November 16 at <http://en.scoop.mk/samsonenko-successful-in-macedonia-under-scrutiny-in-russia/> and Nova TV (2015). "The Russian Samsonenko in the story "Invest in Macedonia Belize", February 6, 2015, accessed on November 16 at <http://novatv.mk/rusinot-samsonenko-vo-prikaznata-invest-in-masedonia-via-belize/>

¹⁵⁰ Samsonenko has also built a big hotel attached to the sport center.

¹⁵¹ <http://novatv.mk/rusinot-samsonenko-vo-prikaznata-invest-in-masedonia-via-belize/>

POLITICAL AMPLIFIERS OF THE RUSSIAN ECONOMIC FOOTPRINT

Since 2008, the Russian government has aggressively deployed its resurgent, resource-based economic power in combination with preexisting security networks, and a skillful use of traditional soft power, in order to exploit and amplify strategic vulnerabilities across the Western Balkans. The Russian soft power toolbox includes media propaganda, as well as historical, religious, and ethnic symbols.

Dating back to at least the 19th century, Slavic Orthodox countries in the region have traditionally perceived Russia as a strong ally in their political ambitions. The Kremlin's support for Serbia's cause in Kosovo and Russia's rejection of Kosovo's independence have strengthened the image of Russia as a guardian of Serbia's interests. Another example is that Russian Orthodox Patriarch Kirill expressed concern over Montenegro's NATO accession.¹⁵²

While domestic Russian media outlets have promoted a shared vision of international relations in the Western Balkans, a network of dedicated Russian institutions in Serbia has fostered feelings of proximity. The network has been expanding in recent years to provide support (including financial aid) to organizations and groups that promote Russian interests. Branches of Russkiy Mir (Russian World) and a representative office of the International Fund for the Unity of Orthodox Nations have operated in Novi Sad and Belgrade since 2005. Attempts to strengthen mutual ties between Serbia and Russia have further intensified since 2013, the same year that the Council of the EU announced Serbia's readiness to start accession talks. At the same time, the Russian Institute of Strategic Research (RISI) established a local branch in Belgrade, its only one in the Western Balkans. RISI's website states that the institute is a major scientific, research and analytical center founded by Russia's President, with the primary goal of providing information to the presidential administration and other state institutions. There are also several other Russian foundations, including the Gorchakov Public Diplomacy Fund, the Strategic Culture Foundation, the Center of National Glory, and the Foundation of St. Andrew, which have promoted Russian interests through various activities: financing projects on Serbia's neutrality,¹⁵³ organizing roundtables and conferences on Russian soft power,¹⁵⁴ and helping to establish Russian centers in Ser-

¹⁵² Dusica Tomovic, "Serbian Church Urges Montenegro NATO Referendum," *Balkan Insight*, January 5, 2016, <http://www.balkaninsight.com/en/article/serbian-church-urges-montenegro-to-hold-referendum-on-nato-01-04-2016>

¹⁵³ NSP (2015). News about project on Serbia's military neutrality. October 17, 2017, accessed on December 25, 2017 at <http://slobodarski.rs/2015/10/17/fondacija-dostojanstvo-i-fond-gorchakov-dogovorili-zajednicku-konferenciju-o-aktivnoj-neutralnosti/>

¹⁵⁴ NSPM (2014). Roundtable on Russian soft power. November 15, 2017, accessed on December 25, 2017 at <http://www.nspm.rs/politicki-zivot/meke-moc-rusije-u-srbiji-mogucnosti-i-perspektive.html?alphabet=>

bia's academic institutions.¹⁵⁵ Several Serbian political parties, including parties that participate in the current government, claimed cooperation with Russia's ruling party, United Russia.¹⁵⁶

Russia has promoted the creation of several Serbian-language branches of major Russian media outlets, often with a comprehensive section devoted to political affairs. A considerable number of online news portals have been launched since 2012 that openly advocate Russian interests in Serbia. Among the most influential are Novi Standard (www.standard.rs), Srbin.info (www.srbin.info), Vaseljenska TV (www.vaseljenska.com), but also smaller portals such as Gazeta (www.vesti-gazeta.com), Fakti (www.fakti.org) Kremlin (www.kremlin.rs), and Glas Moskve (www.glasmoskve.rs). Additionally, the Russian state-owned news agency Sputnik opened a regional editorial office in Belgrade in 2015. In Serbia, Sputnik operates in Serbian through its Internet portal and radio program, providing to local radio stations free content, which is widely used. One of the major Serbian weeklies, Nedeljnik, contains the R Magazin supplement, published by Rossiyskaya Gazeta as part of a project "Russia Beyond the Headlines." Public perception is that the promotion of Russian interests is visible even in the most prominent daily tabloids, such as Informer¹⁵⁷ and Srpski Telegraf. Efforts to penetrate almost all areas of public life are also obvious from Gazprom's donation of USD five million to the Serbian Orthodox Church, which was spent on drawing mosaics in the St. Sava Church. This project is part of Gazprom's comprehensive program for projects in the fields of culture and the preservation of the historical heritage of Serbia.¹⁵⁸

The activities of Russian organizations and their Serbian media counterparts fall into several thematic areas. First, these outlets promote a Russian perspective on international affairs, for example, saying that the current crisis in Ukraine will be more dramatic because of US involvement,¹⁵⁹ or they interpret history through a Russian lens in the spirit of support for the long-term Russian-Serbian alliance. Second, they attempt to discredit Western structures (NATO, the EU) by claiming that these institutions counter Serbia's interests (for example, EU support for Vojvodina's "separatist groups")¹⁶⁰ and that they pose a threat to global peace and stability. Third, they present Russia as Serbia's closest ally,

¹⁵⁵ Sputnik (2017). Opening of the Russian centre on the Faculty of Political science in Belgrade. December 16, 2016, accessed on December 26, 2017 at <https://rs.sputniknews.com/drustvo/201612161109269463-Centar-za-ruske-studije-FPN1/>

¹⁵⁶ Danas (2016). Who are the allies of Putin's party in Serbia?. December 26, 2017, http://www.danas.rs/danasrs/politika/ko_su_saveznici_putinove_partije_u_srbiji.56.html?news_id=321319

¹⁵⁷ Informer (2017). News about new weapons for Serbia as a gift from Russia. December 21, 2017, accessed on December 26, 2017 at <http://informer.rs/vesti/srbija/361738/samo-u-informeru-putin-se-dogovorio-sa-vucicem-vi-cutite-a-mi-saljemo-oruzje>

¹⁵⁸ Blic (2017). Company "Gasprom Neft" with 4 million euros finances a mosaic in the Temple of Saint Sava. April 22, 2016, accessed on December 6, 2017 at <http://www.blic.rs/vesti/drustvo/poceli-radovi-kompanija-gasprom-njeft-sa-4-miliona-evra-finansira-mozaik-u-hramu/ltwylyz>

¹⁵⁹ Sputnik (2017). Recent news, allegedly, about US military activities in Ukraine. December 26, 2017, <https://rs.sputniknews.com/rusija/201712261113945545-karasin-ukrajina-isporuka-oruzje-donbas/>

¹⁶⁰ Vesti.rs (2015). Allegedly, EU and NATO are planing to make new state – Vojvodina. February 16, 2015, accessed on December 25, 2017 at <https://www.vesti.rs/Evropska-Unija/DA-LIJE-VOJVODINA-NOVA-INSTANT-DRZAVA-NA-BALKANU.html>

whose actions are always consistent with the interests of Serbia.¹⁶¹ They emphasize common aspects of Serbian and Russian history, in particular the tradition of fighting shoulder-to-shoulder in the two world wars. Next, they criticize pro-European actions and present Serbia as a country repeatedly humiliated by the EU, as well as by the US, yet still “determined” to become a part of the Union to the detriment of the Serbian society.¹⁶² Finally, Russian media constantly remind audiences of past disputes and conflicts between Serbia and its Balkan neighbors, which seems to aim to deter Serbia’s EU integration and the process of reconciliation in the region.¹⁶³

Russia has used its considerable media clout to reawaken ethnic rifts in the region, in response to which it accuses the West of meddling to attempt to foment unrest and, ultimately, to bring about regime change. For example, Russia sought to influence the outcome of the political crisis in Macedonia following April 2014 elections in Macedonia that started after Macedonia’s then-President Gjorge Ivanov and then-Prime Minister Nikola Gruevski’s government appear to have taken advantage of a Russian propaganda conspiracy theory that the crisis sprung from a Western-funded campaign against legitimate governments in the region.¹⁶⁴ Lavrov backed the Macedonian government’s claims, calling the protests the product of outside manipulation.¹⁶⁵ He had been commenting on the crisis since the first wave of protests in 2015, when he also claimed that Macedonia had been the victim of extremism and would be divided between Albania and Bulgaria. Later, after the December 2016 elections, Russia focused on the alleged Tirana Platform for the creation of a Greater Albania. Russia’s Foreign Ministry statements became regular after 2015, while previously, the Ministry had largely ignored Macedonia. In the tit-for-tat exchange of favors, the Macedonian government refused to join the EU and US anti-Russian sanctions after the Crimean annexation, and President Ivanov attended the 2015 Victory Day parade in Moscow amid a boycott of the event by most world leaders.¹⁶⁶ The Russian media’s emphasis on inter-ethnic relations resonated in Macedonia and the broader region.

The lack of press freedom in Macedonia meant Russian propaganda was able to penetrate the country’s mainstream media unencumbered. Indeed, pro-government media outlets become instruments of direct

¹⁶¹ Srbin info (2017). News on strengthening ties between Russia and Serbia through military cooperation. December 16, 2017, accessed on December 25, 2017 at <http://srbin.info/2017/12/17/putin-definitivno-salje-srbiji-s-300/?lang=lat>

¹⁶² Sputnik (2017). News about US blackmail on Serbia. December 23, 2017, accessed on December 26, 2017 at <https://rs.sputniknews.com/politika/201712231113918663-Hojt-ji-nova-ucena/>

¹⁶³ Srbin info (2017). News about possibility for Dayton 2 which allegedly means disappearance for Republika Srpska (as a part of Bosna and Hercegovina). December 23, 2017, accessed on December 26, 2017 at <http://srbin.info/2017/12/26/sta-se-krije-iza-projekta-dejton-2-pandorina-kutija/>

¹⁶⁴ Marusic, Sinisa. (2016). “Macedonia’s Gruevski Issues Threats,” BalkanInsight, December 17, 2016.

¹⁶⁵ Holodny, Elena. “The Kremlin thinks that the massive protests rocking a Balkan nation are an outside job to hurt Russia,” Business Insider, May 20, 2015 accessed on November 11, 2017 at <http://www.businessinsider.com/russia-lavrov-macedonia-protests-2015-5>

¹⁶⁶ Ivanov was also made doctor honoris causa by the Russian foreign relations academic institute – MGIMO.

propaganda. Macedonian officials, including Gruevski, often repeated Sputnik content word-for-word – which meant the language circulated by domestic media outlets echoed that of the Russian news agency. According to a June 2017 report by the Organized Crime and Corruption Reporting Project (OCCRP) and several regional and domestic investigative organizations, Russia did not limit its actions in Macedonia to disinformation and official statements. The report cited documents leaked from the Macedonian counterintelligence office that showed Serbian intelligence was involved in efforts to support anti-Western and pro-Russian nationalist groups.¹⁶⁷ The documents also revealed how the Russian Embassy in Skopje carried out propaganda and subversive activities since 2006, such as the direct funding of Macedonian media outlets, including those serving the ethnic Albanian minority, to make them into outlets for Russian disinformation.¹⁶⁸ The Russian foreign intelligence (SVR) bureau in Belgrade and the military intelligence (GRU) office in Sofia managed the operations in Macedonia. In addition, Russia has set up over 30 Russo-Macedonian cultural associations, established a Russian cultural center in Skopje and opened two consulates in Ohrid and Bitola to gather intelligence.¹⁶⁹

In addition to Russian intelligence officers, the leaked documents indicated that journalists from the state-owned TASS news agency and a representative of the Rossotrudnichestvo Russian aid agency worked to recruit Macedonian officials.¹⁷⁰ A Rossotrudnichestvo office, opened in Macedonia in 2016 as a result of a 2013 intergovernmental agreement, envisioned the founding of a Russian cultural and scientific center in Macedonia.¹⁷¹ The counterintelligence report also noted that the Russian Ambassador directly told senior Macedonian foreign ministry officials in April 2017 that Russia aimed to make Macedonia, Bosnia and Herzegovina, Montenegro and Serbia militarily neutral countries and complained that the Macedonian government had not reciprocated Russia's support, threatening economic and political consequences.¹⁷²

Further, Russia has directly supported pro-Russian politicians in the region. By supporting Dodik in his 2014 election campaign and the 2016 referendum on RS's national holiday, Russia influenced the entity to slow Bosnia and Herzegovina's integration into the Euro-Atlantic Community. These measures come in addition to financially enabling Dodik's success, for example, through promises of loans with no reform requirements attached, while international financial institutions expected significant economic reforms. Moreover, even when political infighting among the ethnic groups in Bosnia and Herzegovina does not originate due to Russian meddling, the Kremlin has sought to exploit and exacerbate these tensions by inciting conflict over the country's gas supply,

¹⁶⁷ OCCRP (2017). "Leaked Documents Show Russian, Serbian Attempts to Meddle in Macedonia," June 4, 2017.

¹⁶⁸ Ibid.

¹⁶⁹ Ibid.

¹⁷⁰ Ibid.

¹⁷¹ Website of the Rossotrudnichestvo office in Macedonia accessed on December 6 at <http://mkd.rs.gov.ru/ru/about>

¹⁷² Ibid.

the financing of pipelines, the provision of government loans and even national holidays.

Concerning the last point, Russia supported a referendum on September 25, 2016 to keep January 9 as RS's national holiday, which celebrates the entity's founding of the entity during the 1992 – 1995 war, despite a 2015 Constitutional Court ruling to ban it because it discriminates against non-Serbs. Two days before the vote, which the international community protested, Dodik met with Putin in Moscow, where the Russian President gave his implicit support for the referendum. More than 55 percent of voters turned out for the referendum and 99 percent of them approved the motion. Despite strong popular support, Dodik stepped back from his earlier demand for a second referendum – which would have been on independence.¹⁷³

Then, in October 2017, Dodik reiterated RS's objections to Bosnia and Herzegovina's accession to NATO¹⁷⁴ and vowed to preserve the country's military neutrality, an objective the Russian government shares.¹⁷⁵ Earlier in 2017, the RS Parliament passed a resolution supporting neutrality and began the procedure to hold a referendum on joining NATO.¹⁷⁶ In 2015, the government of RS opposed the start of membership talks between Dodik and the EU, calling such a step the biggest treason since the conclusion of the Dayton Accords. Regardless, the Bosnian state submitted a membership application in January 2016, given the two entities' prior approval of the motion to accede. The breakthrough in talks with the EU came about because Dodik was unable to participate in any of these decisions.

Since September 2017, Dodik has reactivated another referendum, initially begun in 2015, to negate the legal powers of Bosnian state courts and the prosecutor. Passing this referendum would make the entity de facto independent from state interference, paving the way to secession.¹⁷⁷ However, the referendum could also serve to divert attention from a corruption scandal involving the Dodik family's real estate developments. To date, Dodik has rejected a direct vote on independence, but he has not ruled it out, saying that such a referendum would not lead to bloodshed.¹⁷⁸ In an interview with Politico, he said that unlike the EU and US, Russia was not "asking him to do anything impossible" and was instead offering "economic cooperation."¹⁷⁹

¹⁷³ Vecernje Novosti. (2017). "Dodik: I want RS to secede, but without any bloodshed." November 13, 2017, accessed as reprinted in B92 on December 6, 2017 at https://www.b92.net/eng/news/politics.php?yyyy=2017&mm=11&dd=13&nav_id=102786

¹⁷⁴ Dodik has not been always consistent, as on occasions he has made statements that the RS government would support NATO accession only if it were backed by a referendum.

¹⁷⁵ TASS (2017). "Bosnia and Herzegovina's Republika Srpska unwilling to join NATO." October 26, 2017, accessed on November 16, 2018 at <http://tass.com/world/972744>

¹⁷⁶ Ibid.

¹⁷⁷ Kovacevic, Danijel. "Republika Srpska Postpones State Judiciary Referendum," BIRN, November 7, 2017.

¹⁷⁸ MacDowall, Andrew. "Bosnia's Serb Republic leader: No breakaway vote next year," Politico, July 3, 2017.

¹⁷⁹ Ibid.

Indeed, Russia has been kind to Dodik. In March 2014, he received an award from the International Fund for the Unity of Orthodox Nations in Moscow, several months before elections in RS. During the same visit to Moscow, Dodik reportedly received donations for his election campaign.¹⁸⁰

It is not surprising, then, that the US Treasury Department's Office of Foreign Asset Control sanctioned Dodik for obstructing the implementation of the Dayton Accords and threatening the territorial integrity and sovereignty of Bosnia and Herzegovina.¹⁸¹ Russia immediately criticized the US decision and firmly backed Dodik. In May 2017, Dodik stated that the EU had been pressuring him to join sanctions against Russia. So far, RS has managed to prevent Bosnia and Herzegovina from implementing the sanctions regime.

In Serbia, apart from the economic links with the Socialist and People's parties described above, the Russian media, domestic pro-Putin organizations and senior Russian policymakers have supported the actions of domestic far right and Eurosceptic organizations. This support comes in the form of high-level meetings, public endorsements, or misleading articles that frame Serbian political space as determined entirely by a battle for influence between the EU and Russia.¹⁸²

Nenad Popovic from the People's Party, a junior coalition partner of Vucic's Progressive Party, has boasted of support from Putin's United Russia party.¹⁸³ In addition, he has advocated against Serbian integration with the EU, and in 2014 publically supported Russia's annexation of Crimea, while serving as the Vice Chairman of the Serbian Parliament.¹⁸⁴ Most recently, during the St. Petersburg Economic Forum in June 2017, Popovic said that Serbia should accelerate its economic ties to the Eurasian Economic Union, a Russia-led regional integration project.¹⁸⁵

The expansion of military cooperation between Russia and Serbia further buttresses Russia's financial and political support. Most visibly, Russia donated six previously used MiG 29 planes; it also promised to deliver 30 T-72 tanks and 30 armored personnel carriers (APCs).¹⁸⁶ Vucic discussed the need to obtain two battalions of Russian-manufactured S-300 anti-air-

¹⁸⁰ Bugajski, Janusz. (2015). "Moscow Upholds Frozen Bosnian State," Center for European Policy Analysis, August 3, 2015.

¹⁸¹ US Department of Treasury Press Center – Treasury Sanctions Republika Srpska Official for Actively Obstructing the Dayton Accords. January 1, 2017.

¹⁸² Knezevic, Gordana. (2016). Serbia and Self-Fulfilling Russian Prophecies. Radio Free Europe, April 29, 2016, accessed on December 19, 2017 at <https://www.rferl.org/a/serbia-self-fulfilling-russia-prophecies/27707245.html>

¹⁸³ Ibid.

¹⁸⁴ RT (2014). "Putin signs order to recognize Crimea as a sovereign independent state." March 17, 2014, accessed on December 4, 2017 at <https://www.rt.com/news/russia-recognize-crimea-independence-410/>

¹⁸⁵ Alo. (2017). "LIDER SNP IN RUSSIA Popovic: Accelerate the integration process." June 1, 2017, accessed on December 4, 2017 at <http://www.alo.rs/popovic-ubrzeni-proces-integracija/109627>

¹⁸⁶ Ibid.

craft missiles,¹⁸⁷ and announced talks with Russian defense export company Rosoboroneksport to procure six multifunctional Mi-17 helicopters, on top of the two such aircraft delivered in June 2016.¹⁸⁸ Yet despite media attention on these developments, Russia's decision to grant Serbia arms and military equipment should not be perceived as a threat or a major turnaround in strategic relations.

Serbia has chosen to purchase Russian military equipment for two reasons. Russian equipment is the cheapest way to modernize the Serbian military, although Russia tends to be selling old military equipment at high prices. Moreover, during the NATO bombing campaign in 1999, the Serbian public perceived Russian weapons as superior; today that perception allows the Serbian government to boost its own popularity by purchasing Russian arms. According to statements by Serbian politicians, both countries would like to expand cooperation to joint production of combat assets and weapons, through direct cooperation of the Russian military-industrial complex with Serbian factories until they are able to produce and export parts for the Russian market.¹⁸⁹ However, Russia's supposed intentions to cooperate in this area are questionable, since the Russian military industry is one of the country's most profitable, and there is no reason to transfer it abroad. It is more likely that Russia is interested in joint arms production only if Serbia can secure the markets for these goods and services elsewhere, especially in the western Balkans and Central and Eastern Europe or even the Middle East, where Russian military technology is still widely used.

However, it is in Montenegro, not Bosnia and Herzegovina or Serbia, where Russia's political meddling has been most aggressive. After the Montenegrin government declared its aim to join NATO in 2014 and adopted the EU sanctions against Russia after the annexation of Crimea, the Russian government began to reverse its decade-long policy of building close ties with the small Adriatic country. The Russian government worked to prevent NATO membership, in particular backing ethno-nationalist groups whose policy platforms are at odds with Western liberal values.¹⁹⁰ Russian Deputy Prime Minister Dmitry Rogozin went even further, saying that Montenegro will regret its membership.¹⁹¹ Several meetings of Montenegrin anti-NATO opposition leaders with Russian officials took place in 2015 and 2016, and representatives of the opposi-

¹⁸⁷ RT (2017). "Serbia wants to buy S-300 missile systems, talking with Russia & Belarus – president." April 16, 2017, accessed on December 4, 2017 at <https://www.rt.com/news/384950-serbia-s300-russia-belarus/>

¹⁸⁸ Gazeta.ru (2017). "Serbia is holding talks with Russia on the purchase of six helicopters, Mi-17." December 2, 2017, accessed on December 4, 2017 at <https://www.gazeta.ru/army/news/10888412.shtml>

¹⁸⁹ Sputnik. (2017). "Ambitious Plans: Serbia Ramping Up Defense Production." May 1, 2017, accessed on December 4, 2017 at <https://sputniknews.com/europe/201705011053162269-serbia-defense-production/>

¹⁹⁰ Bellingcat. (2017). "Montenegro Coup Suspect Linked to Russian-backed "Ultrationalist" Organisation," April 25, 2017 accessed on November 20, 2017 at <https://www.bellingcat.com/news/uk-and-europe/2017/04/25/montenegro-coup-suspect-linked-russian-backed-ultrationalist-organisation/>

¹⁹¹ Rogozin: Crna Gora će zažaliti zbog odluke da pristupi u NATO, Vijesti, January 12 2016, <http://www.vijesti.me/vijesti/rogozin-crna-gora-ce-zazaliti-zbog-odluke-da-pristupi-u-nato-869751>

tion Montenegrin party took part in a gathering of anti-NATO parties from the Western Balkans in Moscow during the United Russia congress in June 2016.¹⁹² They signed a declaration advocating the creation of a militarily neutral zone in the Balkans.¹⁹³ Nevertheless, Montenegro joined NATO in June 2017.

The Montenegrin government accused the Russian Federation of meddling in the 2016 parliamentary elections by attempting a violent overthrow of the government through the Democratic Front (DF), Montenegro's strongest opposition coalition. Both Russia and the DF reject these accusations, and the DF stated the coup d'état was staged by the ruling party, and that all accusations were politically motivated.

The plot in question is now the subject of court trials in Montenegro. The indictment¹⁹⁴ includes 14 accused. Among them are two Russian nationals, Eduard Shishmakov and Vladimir Popov; a retired police general from Serbia and former commander of the Serbian Gendarmerie, Bratislav Dikic; as well as two leading politicians and MPs from the DF, Andrija Mandic and Milan Knezevic. It transpired that one plotter was a member of Russian military intelligence (GRU) and a former deputy military attaché in the Russian Embassy in Poland, who was declared *persona non grata* and expelled from Poland on espionage charges.¹⁹⁵

In addition, the DF allegedly took part in a money-laundering scheme during the 2016 election campaign, in which, it is claimed, the DF received funds of criminal origin from Russia through offshore accounts, sent small amounts of these funds to individuals, and then received the funds back as official donations to the DF.¹⁹⁶ The Special State Prosecutor's Office started an inquiry into DF's financing that thus far resulted in charges against another party leader and MP, Nebojsa Medojevic, and a number of DF activists for facilitating illicit funding flows into party accounts.¹⁹⁷

¹⁹² Representatives of pro-Russian parties from Serbia, Montenegro, Bosnia, Macedonia and Bulgaria were present at the United Russia Congress.

B92. (2016). "Putin's party "secures" Balkans: Sovereignty and neutrality." June 28, 2016, accessed on December 4, 2017 at http://www.b92.net/eng/news/world.php?yyyy=2016&mm=06&dd=28&nav_id=98445

¹⁹³ Ibid.

¹⁹⁴ http://tuzilastvocg.me/media/files/Kt-S_br_271-16.pdf

¹⁹⁵ "Russia 'linked' to election-day coup plot in Montenegro," SkyNews, February 21, 2017, <http://news.sky.com/story/russia-linked-to-election-day-coup-plot-in-montenegro-10775786>

¹⁹⁶ IntelliNews. (2017). "Money laundering probe into Montenegro's pro-Russian Democratic Front extended," August 31, 2017.

¹⁹⁷ <http://www.tuzilastvocg.me/media/files/ZAHTJEV%20SKUPSTINI%20.pdf>

POLICY RECOMMENDATIONS

Russia's economic footprint in the four Western Balkan countries analyzed in this report has visibly expanded in absolute numbers over the past decade. Russian companies have invested close to EUR 2.5 billion in the four countries, half of which has gone to Montenegro, a hub for Russian investment in real estate and tourism. Russia has grown from a peripheral economic power in the region to one of its most significant players. However, in terms of a share of the economy, the Russian presence has remained more or less stagnant amid the expansion of the four economies. Russian companies' revenue as a share of the four economies' total turnover hovers between 6.5 and 10 percent, while the Russian corporate footprint is highly concentrated in strategic sectors such as energy, banking, mining and real estate. Although Russia's corporate presence has been most significant and most diversified in Serbia, until Deripaska's 2013 withdrawal from the KAP aluminum plant in Montenegro, close to one-third of that country's economy was under the direct and indirect control of Russian-owned firms. Even today, Russian FDI stock in Montenegro is close to 30 percent of annual GDP.

Moreover, Russian state-owned and private energy companies dominate the region's oil and gas sectors. These firms gained influence through a series of privatization deals for lucrative assets, such as Serbian companies NIS and Beopetrol, and the Brod refinery and Skopje heating company in Bosnia and Herzegovina. Three countries – Bosnia and Herzegovina, Macedonia, and Serbia – remain almost entirely dependent on supplies of Russian gas, allowing Gazprom to charge some of the highest prices for gas in Europe. Russian companies also have taken advantage of the closed nature of regional oil and gas markets to solidify their dominant position, successfully exploiting delays in market liberalization, the reliance on intermediaries for wholesale supplies of gas, and an unwillingness to advance diversification projects. These are among the governance deficits Russian companies have exploited to their benefit. Further, Russia has locked regional governments into large-scale energy projects, such as the South Stream pipeline, that exceed their administrative capacities. These projects not only sidelined efforts by regional governments to diversify, but exposed them to huge financial risk.

Non-transparent privatization procedures, in which asset valuations did not stem from objective economic assessments, have enabled Russian businesses to expand their economic presence in key industries. In most cases, these companies have not complied with the terms of privatization agreements, leading to losses for taxpayers and state budgets alike. Meanwhile, preferential regulatory treatment, including tax regimes and energy subsidies, allows Russian companies to register enormous profits, expand their market share and minimize tax payments.

To exploit these governance loopholes, Russia has captured local power brokers by offering government-sponsored business opportunities at pre-

mium returns. These intermediaries in turn have benefitted from further business opportunities or Russian support for their political objectives. Ultimately, the concentration of power in small, influential economic-political networks creates vulnerabilities that Russia can exploit to affect decision-making.

Finally, to amplify the effect of its economic footprint, Russia has deployed an array of traditional soft power instruments, including media presence, support for pro-Russian domestic civil society organizations and political parties, and high-level political visits and statements. These tools have been used to support both current governments and opposition groups, depending on what suits Russia's ends. In Macedonia, Russian soft power helped to undermine the legitimacy of anti-corruption protests, while in Montenegro, it aided the opposition in denouncing the government's Euro-Atlantic foreign policy. In Bosnia and Herzegovina, Russian political support for Dodik and RS has exacerbated internal divisions on both the economic and political fronts, successfully diverting the country from its path towards NATO and EU accession. In Serbia, Russia has been mixing politics and business to extract preferential treatment not only in the energy sector where Russia used its support for the Serbian positions against Kosovo's independence to acquire some of the country's biggest companies, but also in the railway, banking and defense areas.

Based on the findings of this report, the following non-exclusive policies should be considered:

- Diversify foreign direct investment away from an overreliance on capital from authoritarian states that is concentrated in one or two industries.
- Improve the corporate governance of state-owned energy companies that are at risk of decapitalization due to long-term deals granting preferential treatment to clients that enjoy special status from the government.
- Separate the management of state-owned energy companies from political parties. Parliaments should approve governmental nominations of professional managers to help ensure the independence of nominees from external pressures.
- Cancel market-distorting energy subsidies that leave state-owned suppliers in difficult financial straits, and even more dependent on single-source imports.
- Fully transpose and implement the EU energy acquis to ensure an unbundling of the transmission and supply of natural gas and electricity, thus promoting the full liberalization of energy markets.
- Mandate national anti-trust authorities to provide regular, (at best) bi-annual assessments of the state of play in markets with considerable economic presence from authoritarian states.
- Achieving better regulatory quality and economic governance through continuous US and EU engagement, assistance and investment. Alone, no single Western Balkans country is a match for large Russian companies, especially those backed by the Kremlin.
- Before approving mergers and acquisitions, anti-trust authorities should monitor companies for possible market concentration risks related to for-

eign investors whose ultimate ownership is hidden behind a network of offshore entities.

- Ensure that all infrastructure projects are consistent with national regulations for transparency and competitive tendering procedures, and subject to independent cost-benefit analysis.
- Strengthen privatization and post-privatization monitoring agencies through the appointment, by parliament, of staff independent from political influence.
- Abolish single-bidder privatization tenders for assets over EUR one million in strategic economic sectors to prevent corrupt, direct back-room negotiations with pre-approved investors.
- Improve the investigative capacity of financial intelligence agencies, tax administrations, and anti-money laundering institutions to identify the ultimate beneficial ownership of foreign investors in order to prevent money laundering.
- Strengthen banking and financial market supervision to flag systemic risks related to the concentration of loan portfolios in strategic industries.
- Create transparent and user-friendly databases of foreign investment in corporations and real estate to improve tracking of potential money laundering operations, and to help identify potential illicit flows of money into the country.
- Expand the data coverage of central banks over foreign investment and corporate ownership, since current statistical data is inconsistent, outdated, and too brief to accommodate a more objective assessment of inflows of foreign capital.

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